Development Southern Africa ›
Volume 22, 2005 - Issue 5

Original Articles

Financial instruments of the poor: initial findings from the South African Financial Diaries study

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Pages 717-728 | Published online: 19 Jan 2007

Cite this article https://doi.org/10.1080/03768350500364125

Abstract

A new data set called the South African Financial Diaries has been produced, based on
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1. Introduction and review of the literature

There is a strange irony when thinking about financial management of poor households. One thinks that by the very nature of not having money, the poor cannot possibly manage the limited resources they do have. However, empirical facts do not support this assumption. In financial diaries surveys in both Bangladesh and India (see Rutherford, 2002; Ruthven, 2002; Ruthven & Kumar, 2002) it was found that the poor tended to manage their money through a variety of financial instruments. In South Africa, the same is found to be true.

The environment within which households operate in low-income countries makes the process of financial decision making quite different for those in developed countries. The life cycle hypothesis (Modigliani, 1970), for example, states that earnings are less than consumption after retirement and exceed consumption during the middle years of earning. Rational people should base their consumption decisions on expected lifetime income rather than current income. However, many researchers (Ando et al., 1992; Deaton, 1993; Spio & Groenewald, 1996) reject this hypothesis in most low-income countries. Savings seems, instead, to be precautionary and held for insurance reasons.

Another classic economic theory, the permanent income hypothesis (Friedman, 1957), proposes that rational individuals will try to smooth consumption if income is disrupted. Therefore, transitory income shocks should have no significant effect on consumption.
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management. Taken altogether, financial flows in poor areas are substantial, but mostly small per transaction.

Ruthven (2002) used the same financial diary methodology in India and her results echo much of what was found by Rutherford (2002) in Bangladesh. The results confirmed that significant sums of money were raised for lifecycle costs. Although they were poor, people allocated disproportionately high amounts to issues related to health. House construction was also extremely important. The results also confirmed that the most widely and frequently used financial device was family and reciprocal contacts. The transactions are small but interest free. Leaning on friends and neighbours is a regular strategy to cover deficits and bridge cash flow. Lastly, they confirmed that slightly different portfolios of financial devices are used by households of differing levels of wealth or livelihood, although all levels of wealth used financial devices. Most respondents were saving by hiding money at home, giving interest-free loans or putting money into a bank savings account. Most were borrowing by taking an interest-free loan, a wage advance or a private loan with interest.

2. Response to the literature and research questions

The approach used by Rutherford (2002) and Ruthven (2002) in Bangladesh and India was shown to provide helpful data on the use of a wide range of financial instruments by low-income households, suggesting that households are managing their money actively in an attempt to smooth consumption in some way. The approach measured how suc … ca, a perspect … to form the context … eds of the poor. Th … e to fill in some of … households.

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3. The Financial Diaries sample

To draw the sample for the South African Financial Diaries, the same method was used as in Rutherford (2002) and Ruthven (2002): a participatory wealth ranking (PWR). In South Africa, this method is used by the Small Enterprise Foundation (SEF), a prominent NGO microlender based in the rural Limpopo Province. Research has shown the PWR process to robustly identify poor households within selected villages and neighbourhoods. Simanowitz (1999) compared the PWR method to the Visual Indicator of Poverty (VIP) and found that the VIP test was seen to be at best 70 per cent consistent with the PWR tests. At times one-third of the list of households that were defined as the poorest by the VIP test were actually some of the richest according to the PWR. The PWR method was also implicitly assessed in van der Ruit et al. (2001) by being compared to the Principle Components Analysis (PCA) used by the Consultative Group to Assist the Poor (CGAP) as a means of assessing client poverty. They found that three-quarters of those defined as poor by the PCA were also defined as poor by the PWR. This study closely followed the SEF manual to conduct wealth rankings on which to select the sample for the South African Financial Diaries data set. After the year-long survey, it was found that the sampling method resulted in a wide variety of household incomes and sources of funds in the three Financial Diaries samples.

Monthly income per household

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Figure 1: Average monthly household income distribution (percentage of households in each area)

Figure 1: Average monthly household income distribution (percentage of households in each area)

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Monthly income per household member

This picture becomes more pronounced when one looks at monthly income per household member, as shown in Figure 2. The United Nations Millennium Development Goals (MDGs) suggest that it is key to assess those living below the threshold of $1 per person per day. The fluctuating rand/dollar exchange rate makes it difficult to determine a clear lower boundary in rand for the Financial Diaries households. We chose to set our lowest bracket at R200 per month or less, which is roughly $1 per day at an average exchange rate of R6.40 per US$.

Figure 2: Average monthly income per household member (percentage of households in each area)

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from regular jobs, while only 5 per cent of income is from grants. In Langa, income from regular jobs accounts for 55 per cent of the average household income, while grants account for 15 per cent of average monthly income. Self-employment is only 10 per cent of household income in the urban and peri-urban areas, while in Lugangeni self-employment income registers a meagre 3 per cent of household income.

Figure 3: Sources of income (percentage of average monthly household income)

Figure 3: Sources of income (percentage of average monthly household income)

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4. Diary methodology

This study adopts the same diary methodology that was used in Rutherford (2002) and Ruthven (2002) in Bangladesh and India, but attempts to build on the information gathered in the first studies to enhance the quantitative output in the South African Financial Diaries study. The sample was also expanded from 42 households to 166 households, and whereas the financial diaries studies in India and Bangladesh were mostly unstructured interviews and open-ended discussions, the South African Financial Diaries uses a combination of closed- and open-ended questionnaires. The initial three questionnaires are structured and gather information on household demographics, physical assets, typical income and expenditure patterns, historical and current employment, and lastly current and previous use of financial instruments. There are

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The households were interviewed every other week for a year, capturing every cash flow coming into and going out of the household, including income, expenditure, changes in physical assets, servicing financial instruments and initiating financial instruments. To facilitate the collection of data, data from the initial three questionnaires was used to produce a diaries questionnaire specific to each household. This was used to prompt memory, aid data collection, save the respondents time and encourage patience. Data was inputted by fieldworkers each week for the previous week's interviews and new diary questionnaires were generated. The diary process was enabled by a specially conceived and built Access Database and the consistent weekly capture of data.

Each week the respondents were also asked if they had done anything new in the past two weeks, for example opened a new bank account, joined a new stokvel (savings club), or stopped a financial device. Each new financial device was captured on a specific form and cash flows generated by that device were captured thereafter. If a financial device was closed, a ‘close’ form was captured and cash flows on that device were not captured thereafter. They were also asked if a major event had occurred, if a person had joined or left the household, if a new or casual job had been taken on or abandoned or if a new physical asset has been bought, sold or stolen. Each week the fieldworker also filled in a journal in which he or she noted various observations, events or comments made by the respondent that had not been captured elsewhere in the diary questionnaire.

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error, the data was corrected. If it seemed to come from a lack of reporting, the fieldworker was informed and told which details to follow up in the next interview. In this way, the data were continuously checked to ensure quality.

5. Initial results from the Financial Diaries data set

The poor hold a portfolio of diverse financial instruments (Figure 4)

Over the course of the study year, it was found that households would use an average of 17 different financial instruments. Some financial instruments, such as a bank account, would 'stay open' all year, while others, such as borrowing between neighbours, would open and close within days. Although credit is the type of financial instrument most often associated with poor households, we found that most households used a variety of insurance, credit and savings instruments. The poor do not tend to use only one type of financial instrument – they manage a portfolio. Most households have at least one credit, insurance and savings instrument. They do not only borrow, and they do not only save.

Figure 4: Average number of financial instruments used during the year (per household)

Figure 4: Average number of financial instruments used during the year (per household)

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Figure 5: Average number of financial instruments used during the study year (per household)

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Most transactions go through formal financial instruments (Figure 6)

All households push and pull a significant amount of money through financial instruments over the course of a month. We capture this activity by turnover. Turnover is calculated by adding the inflows into a financial instrument to the outflows of a financial instrument, over a particular period. In Figure 6, we chose to show August as a typical month of financial instrument turnover in various types of financial instruments.

Figure 6: Monthly turnover for types of financial instruments (rands)

Figure 6: Monthly turnover for types of financial instruments (rands)

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Overall, the average household in the sample in a typical month will transact about R3000 through financial instruments. Not surprisingly, these transactions primarily happen in transactions-based formal financial instruments such as bank accounts. A household getting a payment through the bank – for instance, a regular wage, pension or grant – will receive this money into the instrument plus take the same amount out in a typical month.

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Figure 7: Langa: average use of financial instruments (average = total number/52 households)

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Lugangeni: burial societies are frequently used (Figure 8)

As in Langa, households in Lugangeni have frequent borrowing and lending patterns among themselves, but unlike Langa they are likely to have at least one informal burial plan, as well as one formal funeral policy. They are also more likely than households in Langa and Diepsloot to keep savings in their house. Although more informal financial instruments tend to be used most frequently, this does not mean that households do not have bank accounts. The average household in Lugangeni will have at least one bank account.

Figure 8: Lugangeni: average use of financial instruments (average = total number/60 households)

Figure 8: Lugangeni: average use of financial instruments (average = total number/60 households)

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Diepsloot: bank accounts are more frequently used (Figure 9)

Although very few people have lived in Diepsloot for more than two years, financial ties in the form of lending and borrowing are as common as in the more established areas of Langa … nts more frequent … ast one bank account. … also save in-house

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6. Urban versus rural case studies

The Financial Diaries data set provides a depth of information about households, although it cannot be used as a nationally representative survey. The following two case studies show that, contrary to expectations, some poor rural households can in fact use more financial instruments than a better-off urban household.

7. Conclusion and further research

The South African Financial Diaries project suggests several conclusions about the financial lives of the poor. Poor households have much more complex financial lives, using many more financial instruments, than may have been expected. Using a variety of sources of funds, households managed their money among a breadth of informal and formal instruments, and among savings, insurance and credit instruments. The depth of the Financial Diaries data provides a considerable resource for further research. Research areas to be probed include the extent of indebtedness within the sample, the link between employment and financial service access, methods of savings, the financial impact of shocks and the extent and financing of health expenditures.

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