INTERNATIONAL FINANCE REVIEW

Series Editor: J. Jay Choi

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CREDIT, CURRENCY, OR DERIVATIVES: INSTRUMENTS OF GLOBAL FINANCIAL STABILITY OR CRISIS?

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ARE MICROFINANCE INSTITUTIONS IN DEVELOPING COUNTRIES A SAFE HARBOUR AGAINST THE CONTAGION OF GLOBAL RECESSION?

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ABSTRACT

The global recession has strongly affected the credibility of the international banking system, damaging also the real economy. Developing countries, not fully integrated with international markets, seem less affected and local microfinance institutions might also allow for a further shelter against recession, even if foreign support is slowing down and collection of international capital is harder and more expensive. Intrinsic characteristics of microfinance, such as closeness to the borrowers, limited risk and exposure and little if any correlation with international markets have an anti-cyclical effect. In hard and confused times, it pays to be little, flexible and simple.
1. WHAT DOES THE SUB-PRIME MARKET CRASH MEAN TO MICROFINANCE?

In July 2007, nagging delinquency problems started to crop up in one tiny corner of the US home finance market referred to as sub-prime mortgages. They made the dream of first-time home ownership possible for many. Yet today, an estimated two million sub-prime loans appear likely to default leading to the so-called sub-prime crisis. This has caused a turmoil across the financial markets and global banking systems, as investments and guarantees related to housing prices declined significantly in value, placing the health of key financial institutions and government-sponsored enterprises at risk.

Funds available for personal and business spending (i.e., liquidity) declined as financial institutions tightened lending practices. This turbulence in global markets has restricted credit in most of the world’s major financial centres. This has set off worldwide concerns about the resulting credit crunch and a looming US financial crisis that has led to a global recession, with paper economy hurting and suffocating also the real economy.

Financial institutions nowadays hardly trust each other and are reluctant to lend money to other banks which might be unable to pay it back, due to the presence in their assets of too many toxic and worthless derivatives or other sophisticated assets. Financial opacity and darkness are destroying the value of the underlying real assets, reaching the very core of social and economic stability.

In such a negative scenario, it seems particularly important to detect if—and to what extent—the crisis has affected microfinance institutions (MFIs) in developing countries.

Microfinance practitioners and managers should pay more attention to the latest meltdown caused by sub-prime mortgage market in the USA. Top MFIs have been the recipients of favourable and even subsidized financing from both private and public investors, bankers and international finance agencies entering the industry.

However, due to the sub-prime crisis and the consequent financial crashes, the behaviour of these microfinance investors is most likely to be affected, with a slowdown in the recent bulge in microfinance investment. This could, however, help protect the industry from potential degeneration, since crises always have a cathartic effect and the sub-prime crisis communicates a caution.

Furthermore, like the sub-prime mortgage situation, microfinance has opened a huge, previously underserved market to new investors. The involvement of the private and public investors in microfinance is very important for the development of the industry, even if this might cause a mission drift in microfinance, with new and different targets that might endanger its social focus to the underserved.

To date, the microfinance sector has built a record of extremely low default rates despite rapid growth. This has been due to the close relationship with the clients, solid customer screening and concentration in the poor market. The absence of a close relationship with the client (borrower) and the sophistication/opacity of derivative and other toxic products are another remarkable disadvantage of so many once-upon-a-time successful products of mainstream banks. In hard times, when confusion and panic prosper, the ‘keep it simple and stupid’ rule works and pays.

All microfinance practitioners—investors, lenders and regulators—should operate with caution to preserve this record so as to avoid the existence of exploitative practices by selfish practitioners like for the case of sub-prime scenario. Careful underwriting, risk management techniques and a strong focus on portfolio quality are critical to the impressive repayment performance of microfinance.

The opportunities within the microfinance sector have attracted a surplus of well intentioned but overly zealous investors fuelling the growth, typically, of very young institutions. Will increasing capital flows spur the new microfinance market to grow too quickly? Will microfinance investors stick to their prudent standards even if competitors sprint ahead of them in growth? Will they take the long-term investment view rather than striving to satisfy the short-term demands of investors?

To date, lenders to the sector generally have been prudent with the majority of capital flowing to the top-tier or middle-tier institutions—those with strong, documented track records. The best microfinance investment vehicles have employed thorough underwriting standards, including on-site due diligence; they also negotiate effective loan agreements containing the necessary covenants to protect all parties. Therefore, there is need for all participants, especially new entrants, to maintain the high standards of due diligence set by the successful early commercial investors.

Microfinance is associated with naturally high administrative and operating expenses. As such, microfinance loans require higher than average interest rates. Many expect that competition will result in added efficiencies and a decrease in interest rates. However, during the sub-prime mortgage market, high competition brought few real benefits to borrowers. Will MFIs be enticed to deploy available capital by relaxing their credit standards, relying on what have historically been extremely low default rates and high margins? Could there be a perverse incentive to drive clients to become over-indebted?
Learning from the lesson of the sub-prime crisis, microfinance practitioners, investors and managers should pay close attention to address these issues in order to avoid a possible financial crisis in the industry. Microfinance practitioners should also increasingly depend on credit agencies to monitor client indebtedness to avoid over-indebtedness of their customers, not typical in MFI’s – this being another advantage.

The success of the industry to date has depended on the relationship between lender and client, built on the loyalty of borrowers traditionally neglected by traditional banks. Care must be taken to preserve this relationship. Commercial microfinance stands at the threshold of the capital markets. Success has accelerated in recent years with significant benefits to investors and with enormous benefits to the end clients (the entrepreneurs at the bottom of the economic pyramid).

The problems of the sub-prime industry (predatory lending, loan defaults, complicated loan products, securitization and sale to not fully aware intermediaries of the products ...) are unheard of in the microfinance industry. There is no indication that microfinance will likely follow the curse of the sub-prime industry, but there are potential risks in the evolution of any fast growing industry. Now it is the time to recognize how risks escalate, to learn from the mistakes of others and to be mindful as microfinance industry develops.

Progress is a marathoner while decline looks like a one hundred metres runner.

2. THE IMPACT OF GLOBAL RECESSION ON THE BANKING SYSTEM: ARE MFIs IN POOR COUNTRIES DIFFERENTLY AFFECTED?

2.1. Globalization and Recession: The Asymmetric Impact in Poor Countries

Globalization and international transmission of economic recession can take place through financial, labour and trading markets. Globalization has an impact on the economies of developing countries from three distinctive processes: trade in goods, flows of capital and migration of people.

Recession normally has a negative effect on all the above-mentioned processes, since international trade – and also developing countries exports - declines or even collapses due to lower consumption and consequent adjustments in production; flows of capitals also decrease since savings and financial investments are reduced and addressed to safe harbours; finally, even migration normally declines, if the capacity to absorb foreign workers slows down.

Globalization carries recession around the world, at a pace which is proportional to the degree of integration of the national economies. Therefore, due to the current recession, growth of developing economies is most likely to slow down particularly in those economies dependant on industrialized countries through trade in primary commodities and finance. Lost growth of developing countries caused by lower earnings from trade due to declining commodity prices, slowdowns in the developed world’s markets, lower investments as firms cut back and falling remittances from relatives overseas as they suffer the impact of the recession, will see poor economies struggle with slowing economic performance and increasing poverty levels.

Globalization has always shown to have positive aspects in decreasing the international cost of equity capital for companies accessing to international stock markets – but MFIs in developing countries have hardly been able to benefit from this (being too small, young or neglected to be sufficiently attractive). Now that the wind has changed direction and globalization is proving harmful in the transmission of recession, the same MFIs seem to have a natural shelter.

According to Claire Melamed, ‘While world leaders occupy themselves with how to fix the global economy, the damage being done to ordinary people, particularly the world’s poorest, must not be overlooked. There is a real risk that the financial crisis will precipitate a serious social and economic crisis in poor countries, as their already precarious economies are forced into slower growth or even recession.

Also important to note is that wealthier developing countries especially in Africa such as Algeria, Angola, Botswana, Libya and Nigeria that hold substantial oil and mineral reserves as well as sovereign wealth funds based offshore are more exposed to the ongoing market turbulence through their investment holdings abroad which are experiencing substantial currency, interest rate return and share price volatility and are, therefore, more likely to be affected by the current ongoing global recession. In small non-oil-dependent emerging countries, recession might be milder.

Developing countries can be classified in many different categories and in this introductory analysis we might just concentrate at first on the distinction between countries with or without natural resources and between big exporters of manufactured products (such as China, India, ...) or small exporters of agricultural products (coffee, tropical fruits, ...).
Since with the crisis foreign aid is likely to decrease, the segmentation between the different categories of developing countries might grow: the middle-income countries or those rich in natural resources might still get western aid and attention because they are of much more commercial and political interest than the tiny and powerless markets of the bottom billion, even if the latter are less integrated and more protected from global recession.

Net exporters to Western countries are naturally going to be more affected by global recession, which cools down the price of oil and other commodities or products, since consumption is reduced. The impact of recession can severely harm countries which are already affected by the natural resources trap, due to sharply declining rents and lack of valid alternatives. Natural resources make people lazy and unable to understand the value of savings and diversification of investments.

Boom-bust cycles are difficult to manage and they bring destabilizing volatility consequences, which damage the macroeconomic outlook of the country.

In less integrated and not so developed countries, the effects of the global recession are – as we shall see – somewhat milder.

The unpredictable nature of sovereign political and economic turbulence as well as natural disasters and the world food price crisis, are very painful to the poorest when active, and inflict sudden distress on the ability of individual micro-entrepreneurs to operate.

After the beginning of the sub-prime crisis in June 2007 and prior to the recession of 2008 – officially recorded in November, but starting several months before – there has been the oil and food crisis, due to which the price of commodities and food products has sharply increased, to the dismay of Western oil consumers (especially in the devaluing dollar area) but especially to the detriment and desperation of the underserved, often too poor to use oil and energy products but obviously still looking for survival food in a context of ‘foodflation’. Oil and food prices have shown for the very first time in history to be linked, since alternative and biological sources of energy have reduced food supplies, with an immediate impact on prices. More bio-fuel for the richer balanced by less and more expensive food for the poorest: not exactly a nice and fair scenario. In such a negative outlook, important resources available to the underserved are the MFIs that provide their funding. Implementing elastic measures such as temporary relief from loan repayment and/or additional emergency capital, MFIs can help their poor clients to overcome otherwise lethal contingent difficulties.

However, MFIs cannot be considered immune from these economic problems caused by such economic events and although they can provide, to some extent, a social safety net, they are sooner or later expected to suffer from the general unrest, given the nature of events, if most of its customers are simultaneously affected. The MFIs might themselves be in need of help to withstand even this crisis. This is because in the midst of economic volatility they often face operational hardship from increased arrears combined with accelerated retraction of deposits. Food shortage in poor countries has somewhat affected the local MFIs, since attitude to savings is evidently cut down in case of emergency, credit quality of hungry borrowers naturally declines, together with often underestimated but important psychological side effects: it’s difficult to make plans and projects for the future when starvation is much closer and struggle for survival is naturally short termed and sighted. This is why there is currently a growing concern that the global financial crisis may be hitting local MFIs, forcing them to downsize and re-evaluate their expansion programs.

Therefore, the current recession is most likely to negatively affect poor countries in the form of an economic slow down and as a result MFIs are more likely to be differently impacted depending on the extent to which their host countries are integrated to the international financial market but – no matter the degree of integration – MFIs are likely to suffer in one way or another as we shall see in the following paragraphs.

Money flows via sovereign funds or other investment vehicles from emerging to OECD countries, but with recession it happens at a lower rate, since Western countries might reduce their imports. But emerging countries are very different among them and they are also segmented, ranging from those really emerging to the hopeless poorest (China and India cannot be compared to sub-Saharan countries). Those at the bottom end are the net importers of foreign funds (from Western or other more developed countries, see for instance Chinese investments in Africa).

It is important not to place all emerging countries in the same bucket. Those middle-income countries that are more financially integrated will bear more the direct fallout from this crisis, at least in its first stages.

The target of foreign investments in very poor countries is often oil or other commodities, typically not involved in the microfinance projects since their scale is much bigger and their characteristics are so different. This is why MFIs in Eastern Europe seem to be experiencing deposit runoffs or reductions, while MFIs in Latin America are reporting more cancelled/non-renewed lines and/or delayed disbursements. Asia and Africa each face different challenges as well.
Despite falling oil, commodity and food prices, retail costs do not seem to decrease as much and as quickly as expected and credit has been sharply curtailed on many levels and life at the bottom of the pyramid is more squeezed than ever.\textsuperscript{22}

2.2. Are MFIs in Poor Countries Immune from Contagion?

According to the World Bank (2008a), the benefits of financial development and globalization have come with continuing fragility in financial sectors. Periodic crises have always had real but heterogeneous welfare impacts and not just for poor people; indeed, some of the conditions that foster deep and persistent poverty, such as lack of connectivity to formal markets, have provided a degree of protection for the poor. Past crises have also had longer-term impacts for some of those affected, most notably through the nutrition and schooling of children in poor families.

An important lesson from past experience is that the short-term responses to a crisis such as macroeconomic stabilization, trade policies, financial sector policies and social protection, cannot ignore longer-term implications for both economic development and vulnerability to future crises.\textsuperscript{23}

A comparative analysis of previous recession periods, together with their interaction with microfinance might seem interesting and scientifically sound only if it could envisage a recurrent paradigm, but this does not seem the case, since in previous economic crises microfinance was almost non-existent or much more insulated, wherever existent.

The impact of global recession on MFIs in developing countries is however - luckily - indirect and probably affordable, since the poorest countries are traditionally segmented from the global economies of Western and developing countries (such as BRIC, i.e. Brazil, Russia, India and China) and - furthermore - microfinance clients mainly live in a relatively close environment where the impact of international trading, flows of capital or migration proceeds (mainly remittances) on loans and savings is negligible.

While formal financial markets of underdeveloped countries are - whenever existent - typically weakly integrated, so softning or preventing shock transmissions, labour markets might react differently - for instance decreasing the capacity of Western countries to absorb third world workers and to ease money remittances back home - and trade markets can suffer, since exports to Western countries in recession are typically more difficult.

Empirical evidence suggests that MFIs - especially in already segmented developing countries - are to a significant extent detached from major markets and from macroeconomic conditions and this is why MFIs still remain stable in times of economic crisis. This partly explains why MFIs have a lower market risk if compared to that of other financial institutions.\textsuperscript{24} Also because MFIs mainly focus on developing countries and small entrepreneurs, microfinance doesn't often attract much attention from the International capital markets and, therefore, it is less likely to be affected by the global financial crisis.

With the official credit market shrinking, temptation to go back to informal credit - such as rural money lending - might be the only feasible option for many, especially among the poorest.

The presence of financially strong shareholders is an important relief for MFIs. This is because most MFIs are privately held companies, with the main shareholders generally consisting of both for-profit and non-profit investors, who have a long-term strategic interest and are less driven by market forces. Therefore, the strong ownership structures, with owners who have financial resources and sufficient equity status and closely monitor MFIs, might act as an important shield against the economic crisis.\textsuperscript{25} Cooperatives where shareholders, lenders and borrowers typically align their interests often prove elastic and flexible in hard times, being exempt from the market myopia typical of greedy stock market investors.

The elasticity and flexibility of the MFI plays a major role in softening the effects of the credit crunch. MFIs with good capital adequacy standards are more eager than weaker MFIs to cope with deposit withdrawals or interbank loans difficulties, which have consistently grown in Western countries in Autumn 2008, mainly due to the general lack of confidence in the banking system, which has brought many Governments to unprecedented actions - inter-bank loans public insurance.

The strong repayment attitude of micro-entrepreneurs and other low-income borrowers and the micro-lenders' close ties to their borrowers and local markets plays a role in all the cases. Furthermore, MFIs target the 'unbankable' customers with very low income and virtually no collateral but often these conventionally unbankable customers, prove to be small entrepreneurs with a strong repayment ethics and close ties with the local markets reducing the risks associated with the financial crisis.

Furthermore, microfinance operations are insulated from the economic crisis by the fact that the amounts they seek from credit markets to fund their operations are relatively small and, therefore, do not largely depend on huge international borrowing which makes them less affected by the volatility of interest rates on the international capital market. It is also important to note that MFIs mobilize their own financial resources mainly
domestically in form of savings and deposits from the clients, which are also not so sensitive to the benchmark interest rates in the capital markets and above all, most of them apply sound lending practices. Therefore, the ample savings mobilization helps cushion the effects of reduced foreign sources of funding during the economic crisis period.26

Microfinance shows a lower volatility pattern than equities or bonds quoted in emerging markets’ Stock Exchanges, since it is invested in instruments that are not yet listed and whose value is only partially influenced by unpredictable fluctuations in interest rates, credit spreads and speculative transactions. Microfinance shows a weaker correlation to political or economic events, since it belongs to the informal sector which is by its very nature a thriving source of new businesses, which are somewhat independent of the fate of the formal economy. Similarly, it is weakly correlated with global financial movements in major markets.27

According to Premal Shah, 'Shocks to an economy, like a global recession, affect the informal sector less than the formal sector. For the MFIs, because their clients are in the informal sector, typically the portfolio quality does not decline'.28

Micro-entrepreneurs mainly employ domestically produced goods and services, which make them less exposed to currency devaluations or exchange controls. This insulates MFIs from currency volatility and as a result micro-entrepreneurs are more likely to realize an increase in demand for their less expensive locally produced goods and services as the local market during a recession shifts from more expensive to cheaper imports from countries facing raising inflation levels due to the financial crisis.29

According to McGuire and Conroy (1998), countries with the greatest concentrations of poverty were materially less affected by the financial shock. They also found out that MFIs focusing solely on the poor appear to have withstood the crisis better than lenders not specifically targeting the poor. According to Inter-American Development Bank study on Bolivia (Rodriguez, 2002), institutions serving principally or exclusively low-income women showed a higher degree of sustainability in times of crisis. Women, who represent a large percentage of microfinance clients, tend to have above-average debt service reliability. Therefore, such evidence suggests that MFIs which continue to focus on the poor and maintain close ties with their customers may be able to preserve their resistance to the current global financial crisis.

The superior economic performance of MFIs during times of economic distress is dependant on the close ties to and knowledge of borrowers and local markets, and solid screening and incentive mechanisms to identify and encourage good and strong clients.30

Organizations which provide savings, training and quasi-insurance services bucked the trend of rising default rates and falling lending rates through the crisis perform particularly well under economic slow down.31 Therefore, while the commercial banking sector faces severe problems, microfinance might weather the crisis well. This testifies on the one hand to the strength of the legal and institutional foundations of the microfinance sector, its self-reliance, and the public's trust in MFIs and on the other hand to the absence of the two fundamental problems of the commercial banks such as political interference in lending decisions, and excessive foreign exchange risk exposure of the banks and their clients.

However, as Littlefield (2008), points out, throughout past financial crises especially those of the 1990s (Mexico, Asia,32 Russia) financial services for poor people have shown remarkable resilience to shock. In fact, the loan portfolios of MFIs in Asia during the Asian crisis and in Latin America during various banking crises barely blinked while corporate portfolios collapsed. This is because these banking and currency crises had little relevance to subsistence-based economies in closed ecosystem markets. Our present financial crisis is like no other, and microfinance is far more connected now. Although microfinance still has deep shock-resistant roots, there will be an impact -- both on the institutions and the clients they serve. The medium- and longer-term effects of a global recession are likely to be punishing to poor people.35

Therefore, the interaction of both bad and good news about microfinance during a recession might possibly bring to a new equilibrium scenario.

This is because microfinance is not a foolproof strategy for lenders hit by the effects of recession and MFIs like any other firm will be affected by the recession, depending on countless factors both internal and external, some predictable and some not.

There is, however, little doubt that MFIs will benefit from close ties with their local communities, solid screening and incentive mechanisms to identify and encourage good clients, from having strong ownership structures that includes shareholders with a strong interest in their well-being, from conforming to local financial regulations and from making good use of local savings.34

2.3. Why MFIs and their Poor Customers are Different: Balancing Lower Complexity with Little if any Parachute

In comparing the impact of recession in rich Western countries versus poor and underdeveloped countries, the first obvious consideration is that at the
very bottom line of poverty, there is not much wealth to be destroyed and if this might paradoxically look as good news for the destitute, well we should also consider that they have no parachutes or safe nets and little if any shelter against adversities. The poorest can’t simply lose what they already don’t have! And financial exclusion for the destitute is paradoxically protecting them from the global turmoil, originated and driven by the greedy and cruel rules of an emotionless capitalistic market.

In such a context, bad events such as recession might seem less harmful – since the poorest are much closer to bareness – even if they can give the kiss of death to those – and they are many – who are too weak to stand additional adversities, the last straw potentially being the fatal one.

According to Honohan (2005), an apparent temporary narrowing of income inequality has been observed during several recent banking crises. But it would be a mistake to conclude that such crises don’t matter for the poor. For one thing, the correlation is not strong, and the opposite pattern has also been present. Besides, the poor are much less able to absorb a cut in income: safety-net policies are urgent during a downturn even if the gap between the rich and the poor has temporarily narrowed.

The reaction of the poorest is often silent and their problems consequently underestimated, this being one of the costs of being neglected.

But there is also good news – not to be underestimated. While in Western countries recession – fuelled by global and integrated economies – severely hits the banking system, with immediate and painful consequences on households, a double safety net protects poor microfinance clients:

1. From a macro point of view, the financial and banking system of poor countries is less integrated to the Western markets and this segmentation acts as a protection from the recession contagion: some spill over is unavoidable, but the impact is milder than elsewhere;
2. MFIs operating in poor countries are less integrated among them: while Western banks are increasingly interlinked, both internationally and locally, amplifying the mechanism of transmission of recession through international capital markets and domestic ties, MFIs in developing countries are at the same time weakly linked to international markets and not so integrated among them, especially if we consider the difference between regulated and unofficial intermediaries, which live together in less developed countries, while in Western countries moneylenders and other unregulated intermediaries are typically forbidden.

Since MFIs are typically less affected than commercial banks by recession, they tend to have some relative advantage and might be the target of an increasing demand for funds from clients who are expelled and downgraded from the standard credit market. This is already a reality for MFIs in many Western countries, since many clients are increasingly relying on smaller, less sophisticated banks, closer to their real primary needs.

Since poverty grows with recession, albeit with consistent local differences, MFIs’ clients – already potentially unlimited – might be increasing, so posing new and even more challenging targets to outreach. The loss of confidence in the formal banking system might also bring new customers towards MFIs.

Funding is, however, narrowing also for MFIs, especially if they collect resources from microfinance investment vehicles, donors, remittances from relatives of local clients of the MFI or other international suppliers. Funding capacity can resist if it is sufficiently insulated from global recession and domestic savings from poor rural clients are the best source in hard times, considering also that:

1. they are denominated in the same local currency, so being exempt of foreign exchange risk;
2. savings and deposits from the same borrowers are a simple but effective form of guarantee, particularly precious in difficult times where other kinds of (external) pledges are more difficult to find and consequently more expensive;
3. savings have shown to be even more important than loans for poor households and the attitude to save in poor countries seems marginally less affected than in richer ones, even because psychological pressures and media information are much less effective.

Savings are all about confidence and over sensitive to problems which might trigger run-to-deposits behaviours, especially where no – or not adequate – safety nets are available (well-organized Central banks, as lenders of last resort and deposit insurances).

In Western countries, speculative bubbles are quite frequent, due also to moral hazard behaviours, since when things go wrong, investors expect that the Central bank intervenes ... like a mummy, printing money – a sort of protective put, generously sponsored by the Government and its ultimate shareholders (the often unaware taxpayers). It’s difficult to learn from past mistakes if You know that an undeserved parachute is always waiting for You – private gains and public losses unsurprisingly continue to be very attractive.

The process of bank deleveraging is painful in countries where banks are the pivot of the financial system, intermediating funds for the real economy;
only the unprecedented joint intervention of Central banks has avoided a
dramatic systemic collapse. In places – such as the poorest countries, at the
bottom of the social pyramid – where the banking system is not so
widespread and foreign borrowing is scarce, the impact is more limited,
meaning that being unattractive might paradoxically be an advantage.

But deleveraging can also obstacle growth in sound MFIs whose debt is
limited, since the ability to discriminate between those who deserve credit
and those who don’t is typically less effective in extreme situations –
euphoria (where money is cheap and easy to get) or depression (no money
even for those who deserve it).

The public opinion in Western countries now doesn’t rely as it used to do
on financial markets, even in countries where liberalism is culturally deeply
rooted; trust in the State – the final human problem solver, not always for
the better – and in government aid is conversely growing. On the contrary,
developing countries have no real financial markets to worry about, but
conversely they also don’t have an effective State in which they can trust.

In Western countries, if the banking system stops to refinance the
companies, the State might intervene, this not being the case in the poorest
almost stateless underdeveloped countries. Western banks in crisis deliver
their junk loans to their Central bank and get liquidity in exchange; Central
banks, acting as lenders of last resort, have in turn their parachute in the
State; if the State is unable to meet its obligations and cannot cover its
expenses with taxes or placing Government bonds that nobody wants to
underwrite, it defaults, as it has recently happened with Iceland. And when
the tsunami happens, it is normally very painful and long lasting.

Poor countries don’t have these parachutes, having inefficient and not
properly funded Central banks; for the State it proves hard to intervene.
Since its safe boxes are normally empty (even in many oil exporting
countries, where predatory politicians are particularly ‘active’), tax raising
is difficult, due to the lack of a real and stable tax income and public debt
placement is hard both locally (if people have no money for taxes, they also
have no resources for underwriting Government bonds) and internationally
(would you buy an illiquid bond issued by a poor and risky country in a
weak and devaluing currency?).

International Monetary Fund and World Bank are often acting for these
countries as a long-term lender, but hardly ever to the point of preventing
state crackdowns. No miracles for the underserved, out of sight, out of
mind.

However, the current global recession in developed countries has
generated western contradictory ‘double standards’, since International

Monetary Fund and other governments or international agencies have
always blamed public intervention in the economy of poor countries while
now they are rescuing ailing western banks and other companies with public
money. Example is important, especially when the context is difficult and
western countries, often showing a complex of superiority versus developing
tones, talk the talk, but don’t walk the walk.

Bank rescues have undermined the fundamental rules of capitalism, while
its ailing symbol, represented by Stock Exchanges, is betting and speculating
on the Governments’ actions. Stock Exchanges collect information in order
to allocate capital, possibly in an efficient and convenient way. But when
Governments’ behaviours are contradictory, they get puzzled and lose
confidence. Investors, in turn, stop to trust the financial markets.

2.4. The Paradox of Information Asymmetries: What the Eye
Does Not See, the Heart Does Not Grieve Over

Information asymmetries, consistently stronger in informal markets, are
typically blamed by corporate governance advocates, since they increase the
conflicts of interests between the different stakeholders, making the credit
market riskier and more expensive, so preventing optimal outreach to the
poorest.

These pitfalls are real in any state of the economy, even if during a global
recession they may – involuntarily – represent a natural shield against
market shocks, softening over-reaction and panic selling against price
fluctuations.

Lack of information prevents excess volatility and the sometimes
dangerous comparison between stock market prices and intrinsic funda-
mental value: an exacerbated attention to (speculative and short-sighted)
prices hides real (long-term) values. In Western banks and financial
institutions, assets represented by listed instruments are typically evaluated
using a fair value or a marking to market approach – according to IAS 39 or
other international accounting standards – with a typical pro-cyclical effect,
according to which banks are forced to write-offs losses, devaluing their
quoted assets and this brings down the market price of the banks, so causing
further losses. In a spiral that follows a psychological self-fulfillment process,
difficult to stop. Panic selling proves dangerous and harmful and market
volatility has a typical negative trend, being financial depression stronger
than euphoria. It’s always easier to destroy than to build.
In hard times, it shouldn’t be forgotten that when you’re being shaved, it’s better not to move. Over-reaction and panic selling make losses crystal clear.

The portfolio quality of microfinance does not decline during an economic shock simply because their clients are in the informal sector. This is because economic shocks like a global recession affect informal sector less than the formal sector. And the poorest show an astonishing resilience to endemic shocks.

3. THE IMPACT OF RECESSION ON MICROFINANCE RISK: BAD AND GOOD NEWS WITH A MULTIPLE BLENDING OF OUTCOMES

MFIs operating in developing countries are bound to face some impact during the ongoing global recession despite profiting from the double safety net described in Section 2.3. Bad and good news are blended and interact in many possible combinations, with so many potential outcomes whose forecasts are difficult to make. As Niels Bohr used to say ‘it’s very difficult to make forecasts, especially for the future’.

The table below shows the different types of risks associated with MFIs and their behaviour during the recession period (Table 1).

Liquidity constraints increase risk and might also have unfavourable procyclical effects. Since lack of provision of adequate finance to borrowers can stop their investment plans and undermine their survival capabilities, preventing them to pay back their debt. Increasing default rates exacerbate liquidity constraints, with a spiral and self-fulfilling effect which might prove extremely dangerous, even from a psychological point of view. It takes years to build up trust and reputation whereas few weeks are enough to destroy both.

MFIs in developing countries are very different from Western banks or financial institutions, especially the most sophisticated ones, since they don’t make use of derivatives and other toxic products or excess leverage and are much closer to the ultimate clients, being in direct touch with where risk is generated. The paradigm according to which in the last years many financial institutions that raise funds have got free of lending risk, repackaging and selling it to a chain of intermediaries who in some cases barely know themselves, does not apply to unsophisticated MFIs, who do not suffer from the bad effects of full deregulation.

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| Table 1: The Impact of Microfinance Risks on MFIs during the Recession Period |
|-----------------------------|-----------------------------|
| **Type of Risk** | **Description of Risk** | **Impact of Recession** |
| Country Risk | The likelihood that changes in the business environment will adversely affect operating profit or the value of assets in a specific country. Country risk includes the threat of currency inconvertibility, expropriation, nationalization, or expropriation of assets, exchange controls, devaluation, or other unilateral events such as increases in interest rates. | Recession brings to a domino effect of country risk and credit default swaps on Government bonds show a higher premium, since governments who rescue banks become riskier. Country risk grows in most developed countries and does not bring an immediate threat of insolvency. |
| Political Risk | Closer linked to country risk, political risk is a function of political instability and potential changes in economic policies. This is because political decision-making is influenced by such non-standard factors as economic growth, trade, investment, industrial income, labour and social policies, debt, military and civil war. | Recession risk is most likely to increase during a political crisis if MFIs are always fixed on a political agenda. However, unregulated MFIs are always correlated to macroeconomic situations, they are not directly affected by economic uncertainty and are therefore suffer less political risk. |

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<table>
<thead>
<tr>
<th>Type of Risk</th>
<th>Description of Risk</th>
<th>Impact of Recession</th>
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</thead>
<tbody>
<tr>
<td>Foreign exchange risk</td>
<td>The risk that the financial conditions will be adversely affected by changes in the exchange rates, foreign exchange rates and interest rates.</td>
<td>During a recession, the demand for foreign exchange increases. This can lead to a decrease in the value of the currency and foreign exchange.</td>
</tr>
<tr>
<td>Interest rate risk</td>
<td>The risk that the risk for MFIs will be exposed to a higher risk of interest rate fluctuations.</td>
<td>Weak currencies are likely to depreciate against other currencies, causing a rise in the costs of foreign exchange.</td>
</tr>
<tr>
<td>Operational risk</td>
<td>The risk that an MFI will face a loss due to the failure of a business function or due to the failure of an external event.</td>
<td>During a recession, the demand for microfinance services decreases, leading to a decrease in the revenue of MFIs.</td>
</tr>
<tr>
<td>Credit risk</td>
<td>The risk that an MFI will not be able to collect the principal and interest on loans.</td>
<td>During a recession, the creditworthiness of borrowers decreases, leading to an increase in default rates.</td>
</tr>
</tbody>
</table>

**Table 1. (Continued)**

**Recession and Microfinance in Developing Countries**

Roberto Moro Visconti

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**Note:**

- **Type of Risk:** Financial market risk
- **Description of Risk:** The risk that the financial conditions will be adversely affected by changes in the exchange rates, foreign exchange rates and interest rates.
- **Impact of Recession:** Weak currencies are likely to depreciate against other currencies, causing a rise in the costs of foreign exchange.
- **Operational Risk:** The risk that an MFI will face a loss due to the failure of a business function or due to the failure of an external event.
- **Credit Risk:** The risk that an MFI will not be able to collect the principal and interest on loans.
- **Guarantees:** Strongly linked with credit risk, since the lack of adequate guarantees can undermine the borrower's ability to repay the loan.
- **Collateral Risk:** Highly correlated with credit risk, since the lack of adequate collateral can undermine the borrower's ability to repay the loan.

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**Credit Risk:**

- **Risk:** The risk that an MFI will not be able to collect the principal and interest on loans.
- **Impact:** During a recession, the creditworthiness of borrowers decreases, leading to an increase in default rates. This increases the risk for MFIs, as they face a higher risk of losing their loans.

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**Guarantees:**

- **Risk:** Strongly linked with credit risk, since the lack of adequate guarantees can undermine the borrower's ability to repay the loan.
- **Impact:** During a recession, guarantees become more valuable as they provide security for MFIs.

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**Collateral Risk:**

- **Risk:** Highly correlated with credit risk, since the lack of adequate collateral can undermine the borrower's ability to repay the loan.
- **Impact:** During a recession, collateral becomes more valuable as it provides security for MFIs. This increases the value of collateral as a means of reducing risk.
Recession and Microfinance in Developing Countries

<table>
<thead>
<tr>
<th>Type of Risk</th>
<th>Description of Risk</th>
<th>Impact of Recession</th>
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<tbody>
<tr>
<td>Corporate governance risk</td>
<td>Corporate governance sets the rules of collaboration and the behaviour of different stakeholders that provide microfinance services. Poor management and supervision of the financial system include adverse selection (designing, selection, and moral hazard) of the borrower. In unregulated MFIs, the lack of information about the borrower gives about the quality of assets, and the overrelying on collateral for repayment.</td>
<td>Competition typically grows in recession, as microfinance institutions become more aggressive, straining for survival.</td>
</tr>
<tr>
<td>Mission drift</td>
<td>Mission drift is the risk of translating the poverty mission into a non-microfinance mission. MFIs may have different targets to meet their obligations or be unable to access adequate financing.</td>
<td>During recession, MFIs might lose funding due to the volatile capital markets and less demand for microfinance.</td>
</tr>
<tr>
<td>Reputation risk</td>
<td>The risk of loss from the possibility that the MFI may not have sufficient funds to meet their obligations or be unable to access adequate financing.</td>
<td>The risk of loss from the possibility that the MFI may not have sufficient funds to meet their obligations or be unable to access adequate financing.</td>
</tr>
<tr>
<td>Strategic risk</td>
<td>The risk to earnings or capital arising from adverse business decisions due to management of misalignment of strategies, due to mismanagement, or organization of inadequate resources.</td>
<td>The risk to earnings or capital arising from adverse business decisions due to management of misalignment of strategies, due to mismanagement, or organization of inadequate resources.</td>
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Recession and Microfinance in Developing Countries

ROBERTO MORO VISCONTI

1. The Impact of Recession on Microfinance in Developing Countries

Table 1 (Continued)

The impact of recession on microfinance in developing countries is significant, with borrowers facing increased difficulty in accessing credit and financial institutions experiencing reduced demand. Some of the key effects include:

1. Increased default rates, leading to higher losses for microfinance institutions.
2. Reduced loan disbursements, as lenders tighten credit standards.
3. Increased interest rates, to compensate for higher risk.
4. Decreased capital availability, limiting the ability of microfinance institutions to expand their operations.

Despite these challenges, microfinance institutions have shown resilience and adaptability, innovating new strategies to support their borrowers and mitigate the impact of recession. This includes providing more flexible terms, offering advisory services, and leveraging digital technologies to improve access to financial services.

In conclusion, while recession poses significant challenges, microfinance institutions in developing countries remain crucial for achieving inclusive growth and poverty alleviation. The ability to adapt and respond to economic fluctuations is essential for sustaining their mission and impact.

References:

1. [Microfinance in Times of Recession].
2. [Innovative Strategies for Adapting to Recession].
3. [Case Studies of Successful Adaptations].
Stress tests to which many ailing Western banks are now undergoing, in order to detect if and till which break even point they can survive, might conveniently be adapted also to the MFIs in developing countries, with different possible scenarios and consequent outcomes.

4. FUNDS REALLOCATION AND FOREIGN AID IN A GLOBAL RECESSION SCENARIO

MFIs say lower foreign investments in the wake of a global financial meltdown will affect their ability to meet lending targets. This is because, due to the financial crisis, foreign investors are most likely to jump on ship with signs of contagion, unrest and declining fortunes and transfer their investments to less risky investments in more stable economies. Therefore, more successful and profitable MFIs (mostly tier 1) are more likely to benefit from investors who need to diversify their investment portfolios.

However, the relative scarcity of profitable and sustainable MFIs causes allocation problems and might raise prices of tier 1 MFIs, lowering investment returns. The fittest MFIs might also have excess liquidity to spend, with decreasing marginal returns, creating a higher segmentation with other weaker institutions, unhealthy for the financial system and representing a potential threat to its stability.

In this case, the crisis may attract cross-border investments as foreign investors seek to diversify their portfolios to provide some safety through international investments or borrow local currency at favourable interest rates and finance foreign projects.41

Furthermore, many MFIs depend on financing from local and international banks. They face more pressure today than MFIs that have built a deposit base. Some are already seeing their banks withdrawing loan offers, cutting credit lines, or raising rates. Some banks are even asking for loan prepayment and offering to waive prepayment fees. Steep rate increases are being announced – from 250 basis points in Eastern Europe, to 450 basis points for top-tier institutions in South Asia.42 While the immediate reactions have come from international banks, domestic ones may as well pull back in form of restricting credit to MFIs and private investors which will eventually lead to a significant reduction in microlending financing from both local and foreign investors.43 with a selective and harmful credit crunch.

Also, during a recession, investors always face shortage in liquidity which eventually leads to a fly to quality phenomenon.44 Therefore, in such a situation, investors are more likely to start selling what they perceive to be high risky investments and purchase safer investments.

When a country enters a recession, most investors fall short of liquid capital and become more risk conscious and thus prefer to invest their capital in less risky and profitable ventures (possibly top tier 1 MFIs and sometimes tier 2). Fly to quality is a typical strategy applied by most investors during crises and might bring to a Darwinian selection, where the fittest become the fattest and little if any space is left for the rest.

Therefore, MFIs in their early stages of development and size (tier 4 or unranked), who mainly raise funds from government donor agencies, foundations, NGOs or funding institutions, are more likely to be negatively affected by the recession, due to the contraction of foreign funding and to growing shortage of public funds.

MFIs will also face difficulties in raising more funds to finance their operations as commercial financial institutions shrink their funding, raising the MFIs' cost of debt, with sequential effects shifted to the bottom poor clients and an overall reduction in outreach and growth.

The concentration of the MFI's market can bring to anti-competitive behaviours, formally smarter but somewhat similar to those of monopolistic moneylenders (what a shame ... is the story always the same?)

As Iskenderian explained, 'Money is still there, it's just more expensive. Our network members are uneasy about raising interest rates. So there may be a slowing of growth in portfolios'.45 Therefore, MFIs will have to diversify their sources of funding in form of equity investments, client deposits in local currencies rather than relying on donor money. However – as the crisis worsens – liquidity is most likely to dry up, thus affecting local funding as a consequence of deteriorating micro- and macro-economical activities.

The main casualties in the MFI funding situation during this economic crisis are the structured products that were being used to raise capital, such as Collateralized Debt Obligations and Collateralized Loan Obligations (CDOs/CLOs). Again according to Iskenderian, the CDO structure which of recent has been a very important low cost funding source for MFIs is most likely to stop. Annibale also agrees that CDOs will no longer exist, pointing out that the people and institutions working on them will no longer be available, as the whole financing technique has been discredited and, therefore, will be substituted by other sources of funding, in particular domestic finance from local financial institutions in local currencies.46
During the recession, MFIs are also likely to face more defaulting clients, due to rising interest rates and shrinking economic conditions. This is because as the effects of recession become different, the bottom poor clients endure more pain due to the resulting economic slowdown and increasing poverty levels affecting household incomes; as a consequence, even the position of trustworthy clients might rapidly deteriorate. This is likely to pose a greater risk to the microfinance industry and might undermine one of the industry’s most often quoted statistics, that microfinance has an unusually low risk of defaults. Therefore, MFIs risk facing more losses, as clients face the problems of liquidity and the raising cost of debt in struggling economies.

4.1. Some Empirical Evidence around the World

According to studies by different researchers about the previous financial crisis in Colombia, Peru, Ecuador and Bolivia, MFIs outperform commercial banks in the face of a recession. These case studies also suggest that MFI portfolio quality is less exposed to major adverse market movements than other financial institutions.

During the economic and financial crisis in the Philippines, the recession prompted vendors at public markets to stop borrowing from traditional banks with rigid lending rules and procedures. The vendors shifted to local lenders who specialize in flexible, multifaceted relationships with micro-entrepreneurs. The traditional banks incurred heavy losses because of the recession, while the microfinance-oriented institutions stayed profitable, expanded operations and eventually won the market share from the banks.

Sachs predicts that the current economic crisis can do nothing but significantly cut levels of foreign aid. He said most people in the poorest countries would not be directly hit by the global credit crunch because they had no access to financial systems or collateral to take out loans. But they would likely feel the impact through lack of aid.

Laura MacInnis of Reuters observed that ‘Charitable giving and foreign aid flows are likely to dry up as the global economy sours’.

According to K. Vinod Kumar, this recession could make fundraising more difficult for MFIs in cases where they have not built up proper reserves.

According to Roodman (2008), if we pay attention to history, the latest economic slow down will definitely mean less money for foreign aid programs.

Economic stagnation naturally brings to new poverty since the households’ purchasing power diminishes and unemployment grows in recession (especially for unskilled labour force, relative to the working country), potential marginally weaker clients of MF increase and this might worsen the equilibrium point between demand and supply, since with an increasing demand, supply might become even more rigid. Among the consequences, higher interest rates to settle the supply-demand imbalance are a likely and somewhat unavoidable outcome.

The demand and supply of credit is, however, not fully elastic and so people might wonder why it is easier to buy toothpaste than to buy (borrow) money, since – according to basic economic rules – prices adjust so that at market equilibrium supply meets demand. As a consequence, when demand for toothpaste exceeds the supply for it, price will rise until equilibrium is reached. If the price is too high, some might stop buying toothpaste but those willing to pay the high market price would not have any access problem.

Credit markets are somewhat similar, but they also show important differences, as the Nobel prize winner Stiglitz explains in a seminal paper: even in this case if demand for money exceeds supply, the price (represented by interest rates) grows till it reaches a market equilibrium, but here an access problem might arise anyway and information problems can lead to credit rationing even in equilibrium. This happens because banks are concerned not only about the interest rate they charge on the loan, but also about its risk.

According to Geurts, inflation is another MFIs’ operational cost, which becomes an extra burden on their clients, especially hurting the poorest. In recession, as we have seen in Table 1, inflation risk might decrease, since price pressure and salary expectations cool down, unless there is a particular stagnation scenario. In this scenario, capital outflows and oil crises may affect the macro-economy resulting into an increase in inflation levels, which may lead to increase in deposit withdrawals by the clients.

According to Daley-Harris, surveying microfinance clients in Africa, Asia and Latin America, there are varying degrees in which the crisis is being felt. In parts of Africa, he notes, the crunch is leaving its mark, especially when it comes to food shopping and diet. In one of his conversation with microfinance practitioner in Ghana, he learnt that microfinance clients have reduced the number of family meals from three to two times a day and changed the makeup of meals from more nutritious but expensive food to less nutritious, cheaper food. A microfinance leader in South Africa talked about their clients facing this new increase in food prices. But still, they’re
shouldering the changes that they’re facing by eating less as they are facing this really triple threat - financial crisis, food and fuel. Daley-Harris continues by arguing African leaders to act quickly to hold down rising bank costs and interest rates and to make sure that adequate investment flows in the credit market continue to be available to low-end borrowers, ‘in getting the regulatory environment such that microfinance groups could take an ‘on-lend’ savings’.55

According to Tumusiime Mutebi, the Bank of Uganda governor, the global recession is likely to affect export earnings, foreign development aid, remittances and foreign direct investments to Uganda prompting a fall in the economy growth rate by 8%. It is almost inconceivable that foreign private capital will continue to flow into Africa once there are severe cuts in official aid. This has been worsened by foreign investors pulling out of Treasury bills and Bond market and repatriating their money.56

Therefore, it may be true that microfinance hasn’t been hit yet, but as its investors get hit, microfinance will lack enough funds to advance new loans because lenders can’t fund their investments, and this will compel MFIs to cut back lending so that loan repayments can be used to repay maturing loans, and in this way microfinance will be impacted.

New loans to clients won’t happen, as things get worse, loan renewals won’t happen as the MFIs will need more funds to meet maturing debt obligations. MFIs largely and mainly funded by savings deposits perhaps won’t be much hit by the crisis, if they can keep their depositors; MFIs need to be worried of the likelihood to lose clients at the verge of the general economic downturn. Otherwise in absence of these instances, microfinance should sail through this crisis unscauched.57

Given the current integration within the global credit market, one might think that episodes like the credit tightening of the past several months might have a more damaging effect on microfinance. But it still seems fairly insulated from the recent turbulence, and from that fact may spring an opportunity.

Big financial institutions of all sorts are in dire straits across the globe while microfinance is at the moment only marginally affected. Even as the global financial system freezes and giants like Lehman Brothers collapse, MFIs have fewer problems. While well known financial institutions face defaults big enough to wipe them out, MFIs report virtually zero default.58 Microfinance could come out of the financial crash looking rosy because of its counter-cyclical nature, the argument being that MFIs are less prone to suffer from international macroeconomic events than institutions in the developed world.

This is why some key microfinance practitioners and advocates are publicly voicing their support for microfinance as a stable alternative investment. According to Muhammad Yunus of the Grameen Foundation, ‘The financial crisis has not hit the microfinance system’ and ‘in the middle of all these bad news: microfinance still works. This financial crisis is not the only crisis facing the poor – on top of this there is a food crisis. Recovering from this will be much more difficult and painful to watch’.59 Bill Clinton also said that investors should ‘consider the poor of developing nations as viable investment alternatives to today’s turbulent markets’.60

Roodman also noted that, if the worst happens, all bets are off; otherwise he expects the ‘microfinance’ convulsions to have minimal repercussions for the industry.61

Another factor worth considering is that most foreign investment in micro-credit still comes from people and institutions motivated by charity and already fit to accept greater risk, patiently waiting for later returns. In the world of international aid, during lean economic times, microfinance programs have had the ability to cover their costs and sustain themselves when financing from the big banks dry up.

That is why Daley-Harris remains hopeful for the sake of populations who subsist on incomes of less than one dollar a day meaning that microfinancing terms will be able to withstand the current squeeze. But he says the severity of the current downturn will really test the credit market over the next year, and the outcome is still uncertain.62

Von Stauffenberg reports that ‘In Latin America and Africa, where we rate MFIs, we have so far not felt the impact of the upheaval on financial markets. MFIs are so far doing fine. However, I expect that if the US and/or Europe fall into recession, economies in developing countries should start to feel that pretty soon’.63

However, BBC’s Martin Plaut argues that Africa may actually come out ahead in the crisis, because Africa’s banks have been so conservatively managed that they have almost no exposure to the sub-prime market which is resulted into a global financial crisis. He predicts that Africa’s banks will be safe from the financial crisis being faced by other financial institutions around the world. Africa seems more economically stable than it ever has before, perhaps just by comparison to the rest of the world.

Maybe with African financial institutions holding strong and foreign aid waning, some countries will begin to increase their economic independence.64 So, there is a silver lining to the current global meltdown. This could be the trigger developing countries need to rise to the next level of
development. Therefore, despite the short-term pain it will necessitate, it might not be such a bad thing in the long run.65

Kahn and Jansson of The Inter-American Development Bank (IDB), argue 'the fate of an MFI, like that of any firm, will hinge on countless factors both internal and external, some predictable and some not. But all else being equal, there is little doubt that MFIs will benefit from close ties with their local communities, from knowing their borrowers well, from having an ownership structure that includes shareholders with a strong interest in their well-being, from conforming to local financial regulations and from making good use of local savings'.66

According to Watson (2009), 'some believe that microfinance is immune to the current meltdown of financial markets, citing its resilience to crises in the 1990s and claiming that balance sheets in the sector are impervious to adverse external economic shocks. But one cannot escape the reality that today's microfinance is more closely tied to international capital markets or that this crisis seems unique in both scope and scale. Therefore, it is difficult to ascribe wisdom or rationality to any conclusion that forecasts with certainty a positive outcome for MFIs'.

4.2. Fundraising during the Financial Crisis

Experience and research have found out that during an economic downturn, charitable giving typically slows down. In the previous recession of 1973–1975, donations fell by an average of 1.3% adjusted for inflation. In non-recession years (1966–2006), aid increased by an inflation-adjusted average of 4.3%.67 MacInnis of Reuters observed that 'Charitable giving and foreign aid flows are likely to dry up as the global economy sours'.68

When donor pools dry up, how do not-for-profit MFIs weather downturns?

With growing concerns of a global recession, some MFIs may be wondering how they can prepare for the expected declines in foreign aid and donations. However, MFIs should look at this situation as an opportunity to do even more fundraising, diversifying the sources.

Seltzer noted that non-profits institutions are survivors: 'We're accustomed to wearing our belts snugly and tightening them when the economy takes a turn for the worse'.69

Therefore, MFIs should look at this situation as an opportunity for them to improve and diversify fundraising, in order to finance their growth.

Recessions and Microfinance in Developing Countries

For NGOs and MFIs, fundraising depends not only on households' savings but also on grants and donations from foundations and endowment funds, coherently with their social mission.

Foundations often have part of their capital invested in financial assets (stock market shares, bonds, other financial securities) and, in recession periods, when the capital markets are typically negatively affected by the crisis and the economic outlook is gloomy, proceeds from shares and bonds are typically shrinking (lower if any dividend; capital losses on listed shares; lower Net Asset Value in mutual funds; worsening rating in bonds and sometimes high default levels etc.).

The impact on the net equity can be consistent, especially if listed assets are quoted according to fair value or marking to market principles. Since foundations cannot live without a positive equity, survival actions and strategies in many cases cause a remarkable reduction in subsidies and grants, mostly in a pessimistic scenario where further funding from households is typically shrinking, again due to the recession.

Fixed running cost opposed to ailing revenues might enable the weakest foundations to reach a break even point, endangering their survival possibilities. In such a context, grants and donations might not be a top priority and struggle for survival could implicitly bring to a forced - hopefully temporary - mission drift.

Another aspect to be considered is the psychological effect of recession that induces current or potential donors to cut their offers, especially if they are not strongly motivated or if they are not among the wealthiest. A reduction in households' income is obviously not the same if it affects high net worth individuals or those belonging to the middle or to lower classes, where income reduction and the possibility to lose a job have higher negative effects. In such a negative scenario, donations are among the first 'expenses' to be cut and struggle for survival unfortunately makes many more selfish. The impact on MFIs, particularly those depending on subsidies (NGOs...), can be substantial.

And even lending from Western banks to local MFIs might not be considered a priority, especially if there is a credit crunch or a capital rationing process in action in more developed countries, less eager to shift away funds elsewhere when they are most needed at home.

In a scenario where many Western banks are rescued from bankruptcy with public money, Governments normally ask those banks not to interrupt or decrease lending to local communities. The risk that attention is diverted from underdeveloped areas in such a negative and pessimistic look does not have to be underestimated.
Of recent, there has been a rapid increase of NGOs seeking to transform themselves into regulated MFIs. During the transformation process, NGOs need to raise more funds to finance it. However, since during a recession foreign funding pools dry up, it will be more difficult to raise funds to finance the transformation of NGOs to MFIs, since low funding can be lethal for growing NGOs. Recession has an asymmetric impact and spills over on countries, institutions and people.

More so, even when the local savings and deposits are expected to compensate the decrease in foreign funding for MFIs during an economic downturn, local deposits and savings are not a safe haven for MFIs, because as global economic conditions continue to worsen, micro-economic activities in developing countries are also negatively affected by the economic slowdown and this directly reduces earnings and savings of the low incomes earners, making it increasingly difficult for MFIs to raise local deposits to finance MFIs’ operations.

Due to the general bank crisis, ethical banks in Western countries are now considered more reliable (less sophisticated and greedy, more respectful of the real needs of customers ...) than other banks, so attracting deposits with possible lower costs. The size and importance of these good-hearted (at least in their intentions and mission) financial intermediaries is at the moment limited but their natural attitude and attention towards a social vision might represent a natural bridge for MFIs in developing countries, compensating the reduction of other sources of aid and providing professional skills and competences.

5. SEGMENTATION AS A SAFETY NET FOR INSTITUTIONAL INVESTORS: IS THE UNDERLYING ASSET REPRESENTED BY MFIS LESS RISKY?

In developing countries, local currencies are typically non-convertible and this represents a strong segmentation factor, preventing the integration of local financial markets with the international network. Currency segmentation is stronger in countries which are not pegged to strong currencies (typically the USS) and have higher and less predictable fluctuations, which incorporate a high and volatile country and political risk.

Another powerful element of segmentation is represented by the local (weak, whenever existent) regulation of the domestic financial markets and corporate governance pitfalls, which is a disincentive for foreign investors in the country, thus keeping it apart from the global financial markets. No shared rules, no trust – and no money comes without trust.

Repatriation of foreign funds invested in local underdeveloped economies is another hot issue, which often prevents optimal allocation of funds. Due to this lack of synchronization, the degree of correlation of local markets with the international financial market is low, so allowing for portfolio diversification, albeit this risk reduction is offset by higher local risks, due also to the lack of local efficient systems of check and balance.

For purposes of analyzing country risk, we look at the marginal investor: if he is globally diversified, there is at least the potential for global diversification, while if he does not have a global portfolio, the likelihood of diversifying away country risk declines substantially. Stulz (1999) made a similar point using different terminology. He differentiated between segmented markets, where risk premiums can be different in each market, because investors cannot or will not invest outside their domestic markets, and open markets, where investors can invest across markets. In a segmented market, the marginal investor will be diversified only across investments in that market, whereas in an open market, the marginal investor has the opportunity (even if he or she does not take it) to invest across markets.

Local MFIs can provide risk diversification to international investors and to the extent than local underdeveloped markets are not highly integrated with Western financial markets, foreign investments can benefit from anti-cyclical effects.

International investors, however, face particular risks which are inherent to the very nature of the microfinance sector in developing countries. Apart from the already examined country and political risk problem, there are other concerns, such as:

- lower standards of financial reporting and little if any adoption of internationally accepted accounting standards;
- exchange rate controls, currency devaluations and restrictions on the transfer of private capital;
- liquidity crunches;
- illiquidity of the invested asset, in the absence of secondary markets.

According to CGAP (2008c), institutional investors in microfinance are not seeing significant retail redemptions, but they do expect fundraising in the coming months to be tougher sell. Retail investors are cautious and loath to realize losses in existing investments in order to make money available for new microfinance investments.
Investments in MFIs can reduce the portfolio volatility, since microfinance displays low correlation with global and local market movements. \(^4\)

6. ARE LOCAL MFIS A SMART SOLUTION TO INTERNATIONAL RECESSIONAL PROBLEMS?

The very fact that international flows to MFIs in poor countries might decrease as a consequence of the global recession sounds in principle as bad news for poor microfinance clients in less developed countries, even if the impact is different, according to the source and the destination of funds: while donations and grants to small NGOs are likely to decline – as we see in Section 4.2 – investments in bonds or equity from Microfinance Investment Vehicles might also decline as a consequence of the liquidity constraints in Western countries, even if foreign investments might find a safer harbour in MFIs of underdeveloped countries, if compared to other riskier potential investments (being that the international Stock and Bond Markets are strongly affected by extreme volatility and a glooming outlook, should recession continue).

Funding of MFIs might be slowed down by the international unwillingness to cope with the necessities and the programs of MFIs, even if local funding – essentially, savings from the same clients of the MFI – should be only mildly affected by recession, so keeping a decent spending budget.

The possible country and currency substitution, should local savings at least partially replace international funding, might contribute to decrease the currency risk of the institution (whose loans would accordingly be denominated in the same – local – currency of deposits), easing local independent development and setting local borrowers free of foreign aid.

Good news for the delicate transition to the adult age, even if the lack of foreign aid and expertise might initially hurt, hitting especially small and embryonic MFIs (sponsor driven) which are too young and small to survive without foreign aid.

Sustainability would probably increase in the medium to long term, while some doubts rise for outreach, hit by donors’ capital budgeting restraints. The poorest might suffer more, while the relatively richer might be better off. Trickle down redistribution processes might take a long time to work, to the detriment of the underserved who might not survive long enough to enjoy the benefits.

According to Ferreira, Prennushi, and Ravallion (1999), to minimize the harmful impact on poor people of macroeconomic shocks, sound policies for dealing with crises – and an adequate public safety net – should be in place before the crisis starts. To avoid severe and lasting losses to poor and vulnerable groups, governments and civil society need to be prepared for a flexible response well ahead of the crisis. A key component of a flexible and responsive system is an effective permanent safety net, which will typically combine a workforce programme with targeted transfers and credit. Therefore, during an economic crisis, institutions and government should adopt macroeconomic policies aimed at achieving stabilization goals at the lowest cost to the poor.

Typically, a temporary reduction in aggregate demand is inevitable but as soon as a sustainable external balance has been reached and inflationary pressures have been contained, macroeconomic policy should be eased (interest rates reduced and efficient public spending restored, to help offset the worst effects of the recession on the poor). A fiscal stimulus directed at labour-intensive activities (such as building rural roads) can combine the benefits of growth with those of income support for poor groups, for example.

Key areas of public spending should be protected, especially investments in health care, education, rural infrastructure, urban sanitation and microfinance. \(^5\) Efforts should be made to preserve the social fabric and build social capital. This is, however, easier to say than to do, since during recessions we have seen that international aid decreases and public spending financed by local budget is under stress, due to lower tax revenues (as a consequence of declining incomes) and lower oil and other natural resources rents, wherever available.

Recently, about 35 microfinance investor institutions signed on to the Client Protection Principles, a microfinance industry-wide initiative that encourages providers to ensure that low-income clients are treated fairly and protected from potentially harmful financial products. The Principles are distilled from the path-breaking work of MFIs, international networks and national microfinance associations to develop pro-consumer codes of conduct and practices. While there is little evidence of substantial problems with regard to clients in the microfinance sector, these Principles represent a proactive effort to define minimum standards to safeguard the interests of vulnerable clients. \(^6\) During recessions, sustainability of NGOs and MFIs is harder, but outreach becomes even more important, stressing this classical
microfinance trade off. Therefore during a recession, NGOs and MFIs seek sustainability at the same time increasing outreach to reduce the harmful impact of the crisis and enable the poor clients use the opportunities created by the crisis. However, in such a context the poorest and underserved tend in most cases to be the most hurt. Therefore, more attention is needed to protect the poor from the harmful impact that may be caused by the imbalance of power between lenders and borrowers.

When liquidity is scarce, the bargaining power is obviously in the hands of lenders (suppliers).

The profile of consumer protection is being raised due to a number of forces which policy makers seem increasingly willing to respond to, mostly in places where competition is growing. Microfinance markets are experiencing high growth in consumer lending, driven by profit-oriented providers. As they reach out to inexperienced and more vulnerable borrowers, concerns about ‘reckless lending’ and ‘predatory’ behaviour naturally increase.

In most countries, financial inclusion is moving to the top of the politics agenda, bringing into focus the potential vulnerability of previously un-banked consumers with low levels of both income and education. However, there are growing concerns about microfinance raising the prominence of consumer protection from the potential unintended negative consequences of current economic global recession to the microfinance clients.

There is a strong need for raising awareness across the industry and developing policy and regulatory guidance that strikes an appropriate balance between access and protection. Working with investors to integrate consumer protection concepts and tools with social performance management and corporate social responsibility is also extremely important because it involves identifying appropriate ways, including self-regulatory mechanisms, for providers and their networks and associations to address consumer protection on an industry-wide basis.

Therefore, sound policies for dealing with the crisis and an effective public safety net should be put in place even before the crisis occurs, in order to avoid severe and lasting losses to poor and vulnerable groups. The impact of the shocks on welfare depends on their very nature, initial households and community conditions, and on policy responses. We tend to assume that access to finance always benefits those without it: no credit at all is often better than credit which cannot be paid back. But the sub-prime crisis and growing debt stress in some markets is a sober reminder that credit can hurt rather than help if it’s not well-designed and well-delivered.

MFIs need policy guidelines to protect clients from potential abusive lender and over-indebtedness. Microfinance should put in place clear and specific standards of fair treatment and ethical behaviour and clients should be thoroughly assessed to reduce the levels of credit default especially during the economic crisis.

Individuals who are functionally illiterate, first-time consumers, or different in language or ethnicity from the staff of financial institutions are particularly vulnerable. Even middle-income, relatively educated borrowers may be insufficiently informed about their rights and can be pressured into making poor borrowing decisions.

Climbing up the social ladder is a painful and difficult task, requiring stamina and good luck, and the risk of being pulled back is always present.

In addition to the moral arguments, there may also be strategic reasons for promoting or supporting consumer protection. A number of countries have imposed or are considering imposing interest rate ceilings in the name of protecting clients. Unfortunately these ceilings end up hurting the poorest and most vulnerable customers by shrinking their access to credit. Enhanced consumer protection measures can be a more constructive alternative to new or lowered interest rate ceilings.

Lenders and policy makers alike may prefer this alternative if it avoids undermining the viability of the sector as a whole with artificially imposed rate ceilings.

However, most developing countries do not have the elaborate legal or regulatory frameworks for consumer protection typically present in developed countries.

Consumer protection encompasses all the means necessary to safeguard the interests of consumers who are usually poor borrowers in the case of micro-credit, in developing countries and empower them to know their rights and make wise, educated decisions. The main categories of consumer protection measures are disclosure requirements, lender practice prohibitions and requirements, mechanisms for handling complaints and disputes, and consumer education.

These measures may be applied in different ways throughout the lending cycle.

To be effective, the basis for all consumer protection measures is adequate disclosure of lending terms and conditions, according to which lenders are required to clearly state interest rates and loan terms in contracts and other publicly accessible documents.

Promoting consumer education is usually considered a vital strategy of consumer protection.

Consumer vulnerability is most often characterized by an inability to make informed choices and exercise contractual or statutory rights.
Therefore, consumers need to acquire knowledge and skills needed to make informed and confident choices about goods and services.

According to CGAP (2008b), the following principles should be followed by providers of financial services to low-income clients so as to protect the poor low income microfinance clients:

- Providers of financial services should take reasonable steps to ensure that credit is extended only if borrowers have demonstrated an adequate ability to repay and loans will not put the borrowers at significant risk of over-indebtedness. Similarly, providers should take reasonable steps to ensure non-credit financial products such as insurance are extended to low-income clients appropriately.

- The pricing terms and conditions of financial products including interest charges, insurance premiums and all fees should be transparent and adequately disclosed in a form understandable to the microfinance clients.

- Debt collection practices of providers should not be abusive or coercive and financial service providers should comply with high ethical standards in their interaction with microfinance clients and such providers should ensure that adequate safeguards are in place to detect and correct corruption or mistreatment of clients.

- Providers should have in place timely and responsive mechanisms for complaints and problem resolution for their clients and the privacy of individual client data should be respected, and such client-identified data cannot be used for other purposes without the express permission of the client.

6.2. Emergency Liquidity Facility to Assist MFIs in Crisis

Natural disasters, political and economic crises always inflict operational hardships on individual micro-entrepreneurs. However, the most important resource available to them during this crisis is the MFI that provides low cost accessible funds to boost their operations. Should the crisis persists, MFIs might also be likely to face operational hardships due to liquidity problems resulting from contraction of foreign funding, increased customer defaults, retraction of deposits and increased cost of debt. In such a scenario, MFIs themselves might be in need of help to withstand the crisis.

However, during an economic crisis, public and private donors should show greater eagerness to channel more funds to boost micro-credit so as to protect the small entrepreneurs in developing countries from the bad impacts of the recession. MFIs themselves need to be saved, beginning with recovering their liquidity in order to resume operations. Therefore, there is need for MFIs in developing countries to create an independent fund, with the capacity to disburse resources in a minimal amount of time to meet liquidity needs of MFIs during the recession.\(^9\)

In Latin America and the Caribbean, the emergency liquidity facility (ELF) specializes in providing short-term loans to pre-qualified MFIs that encounter liquidity problems caused by exogenous factors.\(^10\) Therefore, MFIs in developing countries need to create an ELF to provide liquidity in a timely manner to MFIs affected by the recession and other natural disasters.

ELF will provide emergency loans to MFIs to allow them continue their operations without interruptions in their financial activities and overcome liquidity difficulties that occur during the recession. ELF will act as a lender of last resort to MFIs affected by natural disasters or financial crisis.\(^11\) This fund will focus mainly on refinancing sustainable MFIs in form of short-term loans, with market interest rates, so as not to become a substitute for the MFIs’ usual funding sources. This mechanism will help channel resources from different donors, who would like to donate funds to boost micro-credit to the poor people in developing countries who are most likely to be more affected by the recession.

Complementary to the funding, a technical services facility will also provide, as needed, operational rehabilitation and institutional revitalization to the MFI until stability is restored. It will provide technical support to help MFIs improve their risk management and strengthen their preventive measures, a soft spot for most MFIs. Therefore, ELF will advance loans to well-managed solvent MFIs with a high loan portfolio invested in micro-credit, with reasonable levels of default and adequate performance. All components of the loan structure will serve to help pull the MFI out of distress and not cause stagnation through over-indebtedness. Conclusively, this fund is aimed at boosting MFIs during the economic distress to be self-sustainable and to protect micro-entrepreneurs against the operational hardships during the crisis period.

7. MICRO-FINANCE AND MACRO-PROBLEMS: IS FREE CIRCULATION OF CAPITALS HARMFUL FOR POOR COUNTRIES?

In a closed economy, investments equal national savings and a similar – may be not so drastic – pattern might apply to economies which are becoming
less open, due to internal decisions or to external shocks, such as recession and international capital rationing.

On the contrary, free circulation of funds - financial openness - allows capital to freely enter and exit countries, easing international investments and divestures, but at the same time exposing the 'open' country to the irrational behaviour of the financial markets and to speculative attacks that frequently target weaker countries when there is a crisis.

Foreign investors can be useful, increasing the efficiency of the internal market with new products and higher competition; free circulation of capitals also induces a more disciplined macroeconomic policy, reducing the autonomy of the domestic monetary policy and, in particular, forcing inflation rates to converge to prevailing international levels. Discretionary measures are harder to implement, due also to the monitoring policy traditionally associated to debt, reducing corruption and mismanagement.

Dangerous drawbacks are, however, particularly frequent in fragile and underdeveloped environments and costs associated to the loss of sovereignty of domestic monetary policies have also to be considered; market imperfections such as information asymmetries can have harmful effects, neutralizing the benefits of liberalization.

An imitation effect among international investors can bring to over invest in one 'fashionable' country - less solid than it appears - with a self-fulfilling spiral known as herding behaviour. The massive and unexpected inflow of foreign capitals can bring to a domestic currency sharp revaluation, with a negative impact on the country's competitiveness; the target country can, however, be exposed to sudden changes of direction, particularly frequent for volatile and greedy investors, with unexpected divestures due to speculative short-term capital mobility which severely harm the domestic financial system, forcing the government to restrict its economic and monetary policy measures, to counterbalance the exodus of foreign investments.

In synthesis, according to economic theory, international financial integration has a positive effect on income growth, increasing the availability of resources and improving the quality and the workings of domestic markets.

To be or not to be open - and to what extent - is however in practice an Hamletic dilemma for countries with weak financial systems, which should be particularly cautious at addressing this extremely delicate issue.

MFIs are part of this big game - especially larger ones - and can benefit from international cheaper and more professional funding, but at the same time the more they are exposed, the more they suffer when the wind changes direction, even considering their increased dimension. Empirical evidence shows that international investors, such as MIVs, pour lots of funds in a handful of big MFIs, better if quoted in local Stock Exchanges; but money is not for many and over funding of the biggest MFIs can be a problem, with marginally decreasing returns and little risk diversification.

So it might sometimes be wise to behave like Ulysses, putting one's fingers in one's ears while listening to the seductive but dangerous singing of the merry maiden.

8. CONCLUDING REMARKS: FROM CRISIS TO CATHARSIS?

The present analysis of the impact of recession on MFIs is absolutely preliminary and should the negative outlook persist, we might consider additional and structural problems.

The current recession borne in Western countries can be analyzed with different interpretation keys - one being that of the 'clash of civilizations' with underdeveloped countries. Western ideas and values, exported everywhere through the globalization device, are facing unprecedented challenges - and the deeply eradicated idea of the natural superiority of the Western culture, often ignoring or undervaluing local customs and differences, is under discussion as never before.

Microfinance is a neat and clear example, since it gives its humble but useful contribution, like a drop in the sea, to the solution of a primary question: why on hell standard Western banks - so sophisticated and useful in developed countries - are not working in a different context?

What survives at the end of a civilization is culture, not strength and a cultural attitude to complex problems such as financial access for the underbanked poorest so used to catastrophes - is highly wanted and might usefully mastermind deeply rooted but old fashioned approaches to development issues. Disorder, chaos and conflict generate discontinuity and can have a cathartic effect on problems which are often underestimated or oversimplified, desperately in need of a 'benign earthquake' to come to surface.

The high growth evolutionary pattern of many MFIs in underdeveloped countries, strategically planned till the first semester of 2008, is certainly slowed down by the lack of adequate funding, which is a cause and at the same time an effect of the current recession - but the width of this problem is still under evolutionary scrutiny.
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- Make sure that loan officers are informed and attentive to clients needs (this being a plus for MFIs, so different from sophisticated Western financial institutions who in most cases don’t even know their clients).
- Communicate early and often with lenders and investors, in order to reduce panic selling, savings withdrawals and misunderstandings (much more common in a difficult and confused context).
- The good aspects of MFIs (low risk; short repayment instalments; strong connection with borrowers; resilience and simplicity ...) have to be kept and improved.

When issues at home are so difficult and unprecedented, it becomes physically and psychologically harder to take care of the problems—but even of the opportunities—that raise elsewhere. When pessimism grows, it’s difficult to discover opportunities, even if there could be no better timing. MFIs in developing countries risk remaining forgotten and excluded in a limbo, being an out-of-scope safe harbour. And limbo is a silent condition, often neglected and misunderstood but as dangerous as asymptomatic cancer.

Due to globalization, growth is increasingly driven by external factors, if seen from the perspective of a single country. Global recession brings in an international constraint to growth and should it more severely affect richer countries, as it now seems to happen, it could reduce the gap between Western countries and the poorer ones, who have missed the boat of global development and are stuck in the swamp.

The impetus for change must come from within each society and it proves wise not to depend too much on ailing neighbours or overestimated Western paradigms. And the changes must be real and substantial: many poor countries have changed their names in the past decades. But it seems much easier to rename countries than to change them.

NOTES

1. Sub-prime mortgages are higher cost home loans to borrowers unable to qualify for traditional financing. For the impact on microfinance, see Cgap (2008a).
2. The sub-prime mortgage crisis is an ongoing financial crisis characterized by contracted liquidity in global credit markets and banking systems triggered by the failure of mortgage companies, investment firms and government-sponsored enterprises which had invested heavily in sub-prime mortgages. The crisis, which has roots in the buying of the 20th century but has become more apparent throughout 2007 and 2008, has passed through various stages exposing pervasive weaknesses in the global financial system and regulatory framework (see http://en.wikipedia.org/wiki/Subprime_mortgage_crisis)

- Increase reserves and capital adequacy (easier to say than to do, since funds are scarcer and more expensive to raise).
- Decrease dependence on foreign funding and raise more local money. Insure of currency risk and more synchronized with local taxes and economic conditions.
- Cut back on excessive growth (with a mixed impact on sustainability). But always bad for outreach.
- Focus on portfolio quality - following a 'fly to quality' paradigm which is typical of any crisis (when money is less, it becomes more selective), especially when foreign funds are scarcer.
4. The recession period is a significant decline in activities spread across the economy lasting for more than few months, visible in industrial production, employment, real income and wholesale–retail trade. A recession is characterized by different attributes that occur simultaneously. For instance, during a recession, critics point to imports that displace domestic production, putting a lead to unemployment and low demand for domestic goods and services. Therefore, there are declines in coincident measures of overall economic activities such as employment, investment, and corporate profits. recessions are the result of falling demand due to either inflation or deflation and sometimes stagnation. Inflation refers to an economic condition of raising prices in the local market while deflation refers to falling prices and stagnation is situation where an economy is in stagnant growth.
9. See Collier (2007, p. 80). Physical borders for workers are still the hardest to trespass and mobility of capital is much easier than immigration.
12. See Section 4.
15. According to Cgap (2008e), when a family already spends 80% of their income on food and the prices double – what do they do? The food crisis affects poor people most acutely. Foods that are mainly consumed by the poor have seen some of the largest price rises; sorghum rose 95% in 2007–2008. Some of the causes of the food crisis – food shortages, un-manageable price increases for poor and very poor households, and export controls – demand rapid action. Others – such as increased bio-fuel production, low agriculture productivity in Africa, and weak market infrastructures – will require longer-term solutions.
17. This has already happened for instance in Bangladesh, as a consequence of disastrous floods which have simultaneously affected most of the MFI’s customers, with systemic problems that proved too deep and wide to be conveniently diversified.
25. See Kahn and Jansson (2007).
27. See Krauss and Walter (2008).
30. See Kahn and Jansson (2007).
32. For an analysis of the Asian crisis, see Choi (2000).
34. See Cgap (2008c).
35. As we shall see in deeper detail in Section 6.1. See also Bauerje et al. (2006).
36. See Sections 4 and 5.
37. Emigrants belonging to the second generation tend to soften their links with their parents or grandparents’ motherland (‘far from the eyes, far from the heart’), so decreasing the rate of their remittances, even if their economic standards typically grow. With further generations rediscovering their roots, links may however strengthen.
38. Cross-border financing of domestic banks decline substantially. Foreign investors also withdrew from fixed income, public equity, and private equity markets. It is also reported that IPOs worth more than $30 billion have been cancelled in emerging markets in 2008. See also Stulz (1999).
39. Trying to limit social costs of default and subsequent contagion with not for free use of public money financed by higher taxes or increased public debt.
40. For an empirical analysis of how Jamaica successfully managed a financial sector crisis during the 1990s, without the assistance or involvement of the IMF, see Kirkpatrick and Tennant (2002). Lessons from MFI’s to Wall Street are described in Microcapital (2008a).
42. See Littlefield (2008).
43. See Gruvsk (2007).
44. Developing-country interest rate spreads have sky rocketed and equity prices have plummeted. Spreads on sovereign bonds have reached 650 basis points and those on commercial debt (which until recently had been the most important source of developing-country finance) have jumped to more than 900 basis points – up from levels below 200 basis points as recently as June 2008 (see http://web.worldbank.org).
45. See Microcapital (2008b).
46. See Microcapital (2008b).
47. According to Gonzalez and Rosenberg (2003), MFIs significantly outperform commercial banks in the face of an economic crisis. While studies by Jansson (2001) on Colombia, Peru, Bolivia and Fonseca (2004) on Argentina, Ecuador and Bolivia, Duff and Phelps on Colombia (Aristizabal, 2006) and Patten, Rosengard, and Johnston (2001) on Indonesia found out that although MFIs are not immune to macroeconomic shocks – they tend to be significantly less affected than commercial banks. Furthermore, MFIs seem to recover faster from times of economic distress than commercial banks (see also Rhyne, 2001).
48. See Kahn and Jansson (2007).
52. This example is taken from World Bank (2008b, p. 31).
54. See Microcapital (2008b).
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Several are now providing local currency loans (http://www.forbes.com/2007/12/20/elizabeth-littlefield-microfinance-biz-cz_el_1220littlefield.html).

DC2480208072009-1.html. According to the study, many of the main risks — or banana skins — stem from the recession: credit risk (no. 1 on the list of concerns), lack of liquidity (no. 2) and funding (no. 6), and declining profitability (no. 12). In contrast, a 2008 survey had credit risk at 10 on the list, liquidity at 20, funding at 29, and profitability at 22.

86. The portfolio quality might improve, expelling the marginally worse clients, but also deteriorate, if borrowers have an incentive for reducing repayments (no more money, no more back).

ACKNOWLEDGMENTS

The author wishes to thank Geoffrey Baluku Muzigiti, Christina Padilla, Damian Leonardo Rocas, Bernhard Vester for their helpful comments. The usual disclaimer applies.

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55. See Microcapital (2008a).
58. See Times of India (2008).
60. See Microcapital (2008b).
62. See Microcapital (2008c).
64. See Basczewski (2008).
66. See Kahn and Jensen (2007).
67. See Giving USA e-newsletter, Spotlight (2008), September.
68. See Reuters (2008); see also Hall (2008).
72. See Deutsche Bank (2007).
73. See Section 3, Table 1.
74. See Krauss and Walter (2008).
75. See Department Of Trade And Industry, South Africa (2006).
78. For a survey of these well known problems, see Moro Visconti (2008).
80. See Bate (2007).
81. Emergency liquidity facility is a fund to support microfinance institutions in case of emergency. An example can be given by the ELF located in San José, Costa Rica with operations through out Latin America and the Caribbean. ELF has more than US$10 million available to assist in emergencies. ELF was created with the participation of bilateral and multilateral institutions, as well as private investors. ELF’s purpose is to serve as a lender of last resort to MFIs affected by natural disasters or man-made crises. http://www.emergencyliquidityfacility.com/que_es_eng.php
84. Public commercial-investment agencies, such as the World Bank’s IFC, the German KfW or the European Investment Bank, are currently the largest investors in microfinance. IFC, for example currently has $640 million in outstanding commitments to microfinance and plans to double this amount over the next 3 years. These investors offer equity, loans and guarantees — and were a natural follow-on from the early grant money that helped build MFIs into credit-worthy investments.
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