

MACROECONOMICS AND MICROFINANCE

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The current global inflationary spiral has prompted the IMF chief to alert about the consequences it has for the poorest of the population. In his latest statements, Mr. Strauss-Kahn follows classical western economics thought: the poorest fifth of the world population make wages in the local currency, and in inflationary environments their wages are adjusted at a slower pace than price rises, eroding their purchase power over time. The higher the inflation rate, the slower is the wage adjustment. On top of that, the classical economic thinking goes, the poorest segments of the population don't have the inflationary hedges richer people have like moving their assets to gold or other less inflation-sensitive assets class.

This line of thinking has two central assumptions: First, there is an asset the owner *cannot* dispose immediately (e.g. "frozen" savings in the bank, wages to be paid at the end of the week and/or other accounts receivables); second the asset is denominated in the national currency being devaluated due to inflation.

This set of ideas are extremely compelling in the *developed* economies where most of the population is wage-earning employees (unemployment rates have been around the 8% average the last 50 years) and poverty is a marginal concern ("endemic" poverty in the G7 countries is less than 1% of the population, mainly as a consequences of other concomitant factors –e.g. mental health, physical handicap, substance abuse)

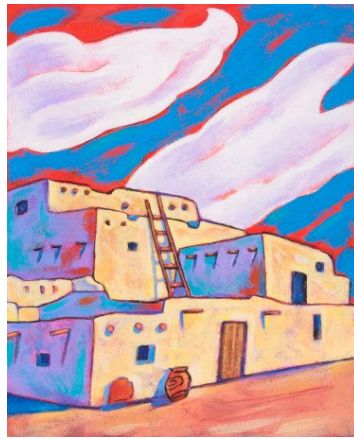


The contrasting situation in emerging economies

Emerging economies offer a sharp contrast, characterized by unemployment and sub employment rates of above 70%; poverty levels above 40%; a significant portion of the economic activity being

informal outside of any state monitoring and taxing. In these latitudes, the poorest fifth of the population likely do *not* earn regular wages, and live mostly out of locally transacted goods and services. Three salient characteristics of this markets can be pointed: **(a)** a significant part of the transactions are *barter* or cuasi-barter transactions: agents tend to operate

through simple “mental accounting” in two “ledgers”: accounts *receivable* from their neighbors and accounts *payable* to their neighbors. Minimal or no cash is involved and the transaction is denominated in terms of the goods to be exchanged: (e.g. one pound of rice for two pounds of coal). Since there is no cash involved, and their transaction is not indexed to any currency, the accounts payable/receivable act as a *natural hedge* against inflation **(b)** these tend to be *rural settings* without much connection with the global economy. (Furthermore, Development economists tend to agree that it is the lack of trade and linkages with other economies what keeps these regions poor). As a consequence, a global inflationary spiral is irrelevant, since the linkages with the global economies are not there. Whatever happens in the world, for good (development) or bad (inflation), is not *necessarily* happening there. For instance, while a country can import inflation through their need to import increasingly expensive oil, this small village’s dramatic isolation isolates them from development *and* inflation. Finally, **(c)** Transactions are remarkably small, as



the market agents have not savings capability being theirs a subsistence economy (single serving soups are a best seller in Mexico and India, based on the consumers’ ability to pay for one at a time, and their inability to purchase and store large packages). This lack of assets implies that the poorest of the poor don’t have anything to get depreciated through inflation! Inflation is a concern of those that do have something to be depreciated, like the blue collar’s worker savings in the U.S. bank or his devalued paycheck at the end of the month. In the absence of assets, paradoxically, the concerns on inflation also disappear.

The significant contribution of Microfinance

Microfinance has played an important role in the poverty alleviation efforts the last three decades. Capital fuels the machines of economic growth: As the micro entrepreneurs increase its productivity thanks to micro credits, the local economies grow and trade with other geographies become real. These improved economic conditions lift micro-entrepreneurs while making them more

vulnerable to inflation. The micro-entrepreneur's illness of the childhood are gone, but now they are exposed to the illnesses of the grown up's. How? (a) Barter transactions recede and the influx



of capital increases the amount of economic activity being transacted in the local currency, which is losing purchasing power as time passes by. The micro-entrepreneur "cash cycle" becomes a significant hurdle. The cash he gets from sales *after* his economic activity is performed might not be enough to pay for supplies for the new cycle of economic activity, a couple of days or weeks after (b) Linkages with the global economies make them prone to inflation import by the way of an increase price of supplies now imported from other villages at the national or even international level. Worldwide prices do impact them now. (c) The increase in their savings capacity

makes the risk of any savings in the form of assets denominated in the local currency to depreciate.

These three elements: transactions being nominated in local currencies, new linkages with the global economy, and increased savings generate a new scenario for the micro-financed entrepreneurs which are for the first times exposed to the global macroeconomic trends.

Is there anything to be done?

The efforts of the Microfinance institutions face a new challenge. Their success or failure is now associated with the global economy. For the microfinance institutions to succeed, they need to add to their tasks not only the provision of capital and financial literacy, but provide the ailments to the global economy maladies. This is a major undertaking.

The expansion of financial services to the poorest brackets of the population have seen an enormous expansion in the latest decade as significant publicity was gained after Mr. Yunus's Nobel award. Deutsche Bank has suggested that this is a \$250B market, and new financial products have been slowly released (investment banks have invested in BoP securitized debt, climate insurance has been rolled out, etc.) Microfinance institutions might want to

explore the use of inflation hedging mechanisms either via embedding them in their loans or as a standalone offering. The explosive boom in global derivatives trading might provide an interesting field where experience might be “imported”.

Sustainability of the Microfinance organizations

On the supply side, microfinance institutions face their own share of problems. As their loans for the most part are fix interest and not indexed to the inflation, in an inflationary environment they will get payments in devalued currencies and thus, their might experience net loss. Depending on their managers ability to generate inflation risk hedging strategies they will fare this inflationary period with success, or simply will be forced to reduce their capital base and take significant write off from loans that are underperforming in real terms. Nothing big banks have not seen lately.

