The Economist

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Covid-19 is causing a microcredit crunch

Lenders deserve relief, belief and a dose of red tape

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ACROSS THE developing world vast numbers of people have lost their jobs or seen their incomes fall. Many are being forced to sell their meagre belongings to pay for food. Ideally state handouts would plug the gap in their finances, but in many countries the public coffers are empty. Often people are too poor a credit risk, or live too remotely, to get help from banks. Microcredit, a form of lending tailored to them, should be part of the answer, but the industry is flunking one of its biggest tests.

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In the 1990s and 2000s microcredit was one of the next big things in development finance. In 2006 Bangladesh's Grameen Bank and its founder, Muhammad Yunus, won the Nobel peace prize. The industry's champions developed a grand ambition. Letting the poor borrow and invest, they argued, would unleash their inner entrepreneur and allow them to earn their way out of poverty. A new model emerged. Instead of demanding collateral, which few poor people have, loan officers judged

creditworthiness by assessing expected income. Lending often went to groups of people, who knew and monitored each other better than banks could. That also saved officers time and hassle, creating efficiencies that enabled clients to borrow small sums at affordable rates.

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Today the lending portfolios of microfinance institutions (MFIs) are worth a combined $124bn. But the industry is in trouble. Covid-19 is straining its finances. Repayments, usually done in cash and in person, have plummeted, yet the banks and investors which provide the MFIs with funds still expect money. A crunch looms. More than two-thirds of MFIs have cut lending, often by at least half, according to CGAP, a think-tank in Washington. Nearly one-third do not have enough cash to meet outflows this quarter. If only this were the industry's only problem. Compounding it is a set of deeper, longer-standing issues that have begun to undermine its reputation for efficiency and probity (see article).

As the industry has grown in size it has also grown in complexity. From insurance to leasing, a lengthening suite of services has turned microcredit into microfinance, adding new players to the fray. A mishmash of regulators have struggled to keep up. Patchy regulation and lots of loopholes have become a serious problem as the industry's high repayment rates—well above 90% on average—have lured for-profit lenders, some of which demand land titles as collateral, charge extortionate rates and use heavy-handed tactics to collect payments. From Congo to Kosovo, scandals have surfaced.

An expanding body of academic research suggests that microfinance consistently falls short of its boosters' admittedly high expectations. Among the economists who have plucked at its laurels are last

year's Nobel prizewinners, Abhijit Banerjee and Esther Duflo. They and others have found that its effects on investment, revenue and consumption are small and uncertain. The result is waning interest in the industry from blue-chip investors and donors.

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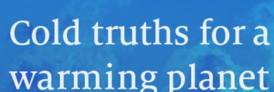

The timing is terrible. People use MFIS for a variety of needs, from buying goods to helping relatives.

What matters is less what the funds are spent on than households' and firms' ability to smooth their income and outgoings over time, which is particularly important when bad news, or a bad season—or a pandemic—strikes. Without microcredit, covid-19 means more people in desperate situations will turn to loan sharks and pawnbrokers, at the risk of falling into debt spirals.

What to do? In the short term, viable MFIS need support. Donors and investors should consider moratoriums, reschedulings or injecting capital. Nearly half of MFIS say they have not had any discussion with funders yet. Supervisors may need to loosen reserve requirements to provide breathing space. Forbearance with struggling clients should be tolerated, as long as MFIS sketch out a path back to normal for when the pandemic is over.

In the longer term governments need to crack down on predatory lending and make rules more consistent and uniform. That will prevent vulnerable people from being exploited and also help restore confidence in legitimate microlending firms. Calibrating regulation is not easy, but some obvious measures include better information-sharing, so MFIS know what they are doing and people can shop around; an obligation to properly assess borrowers' ability to repay; transparency on rates and fees; protection against harassment; and credible grievance mechanisms, advertised in information campaigns. For governments battling deep recessions microfinance may seem a sideshow. But all MFIS together have 140m customers, so nursing the industry back to health will give a big bang for the buck. ■

Clarification (August 17th 2020): This article has been amended to include the source of the data on MFI lending.

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The world economy has to be revitalised in inclusive ways

Raghuram Rajan

A perfect economic storm engulfs industrial countries. Even before the pandemic, US-Chinese geopolitical rivalry impeded global trade and cross-border investment. The pandemic skewed demand towards bicycles and away from gym memberships.

Then rolling lockdowns across the world disrupted production of those bicycles. Ordinarily, the rise in prices of bicycles would have quelled demand, but the enormous fiscal and monetary response to the pandemic in advanced economies kept household spending power strong. Even as jobs came back to cater to this demand, workers became harder to find, because older workers decided to retire and immigration slowed. The mix of strong demand and limited supply ignited inflation, which has spread well beyond the narrow set of goods that set it off.

The war in Ukraine and spreading lockdowns in China add to the turmoil. Both slow growth, while the war fuels food and energy inflation and the Chinese lockdowns drive goods price inflation. Of course, the war could spread further in catastrophic ways.

Spare a thought for developing countries, where matters are, if anything, worse than in industrial countries. Public spending in the pandemic has been very constrained. Many middle-class households have lost livelihoods and slipped into poverty.

Now they face higher energy and food prices that threaten to reduce consumption below subsistence levels. With interest rates rising, their governments are hamstrung by past borrowing and do not have the capacity to help. All this presages more protest and political conflict across the developing world, and more emigration to safer climes.

On current trends, the future looks challenging. Sustained growth depends on innovations that allow us to produce more at lower cost. While the pandemic has forced firms to rethink work processes — working from home saves time on dressing below the waist and on commuting — substantial gains will probably come only when the impediments to delivering services at a distance are reduced; telemedicine will not grow if local licensing requirements stand in the way of doctors prescribing at a distance. Absent reforms, productivity growth is unlikely to be higher than the pre-pandemic pace.

Similarly, population ageing will continue shrinking the labour force, further slowing growth. Deglobalisation through reshoring and friend-shoring, and the consequent fall in global trade and investment, will make it harder for developing countries to grow and substitute their demand for falling industrial country demand. Military spending will increase everywhere, but that will detract from much-needed investment, most importantly in combating climate change. Variants of secular stagnation therefore loom once the storm passes — no wonder 10-year real rates in the US are still around zero.

At best, if central banks raise rates enough that everyone believes inflation will come under control, but not so much that the economy craters, they will slow demand gently. The labour market will come off the boil, even while supply chains stabilise. We will land softly, but into growth lower than before the pandemic. At worst, we will have a recession augmented by financial stress, as the world chokes on high rates and high levels of debt. Central banks cannot get us out of our predicament.

To get better outcomes, we need to revitalise growth through policies to raise investment and productivity. Ending this destructive war would be a first step, but let us discuss what comes after.

The easiest solution economically, and the hardest politically, is to reverse the trend to deglobalisation. By all means, firms should diversify every element of their supply chain. They should also embed flexibility so they can minimise chokepoints. But firms and governments should not aim to do business only among friends. And the IMF and the World Trade Organization should work on rules of conduct and penalties for violation that will protect global trade and investment even as the world divides into political blocks.

Indeed, we should find ways to enhance global trade in services that the pandemic, Zoom and other technologies have made possible. That will require negotiations in areas such as licensing requirements, data privacy and protection, and dispute resolution, but can bring competition and productivity gains to sectors that have long been resistant to change. A collateral benefit is that this could reduce income inequality within countries and across the world.

Perhaps most important, we should band together to fight a war we are losing, against climate change. Much of the world’s emission-heavy capital needs to be replaced. Embarking on this task can be the boost the global economy needs to jump start its way out of stagnation. The world’s major economic powers need to come together, with clear plans for their own actions over the next decade and for the ways they will allocate responsibility for financing climate responses in the developing world.

More generally, we need bold policy action, breaking free of growing political constraints that limit our ambition. It will not be easy, but it is necessary, perhaps to our very existence.

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