



The Impact of Financial Crisis on Growth, Poverty and Hunger in Asia and the Pacific Region

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Enabling the rural poor to overcome poverty



Dynamics of financial crisis

- **Boom:** Banks overextend their balance sheets with higher asset values and lower perceived risks → financial imbalances build up → economic activity is boosted → further rise in asset values, perceived risks decline → further lending and economic expansion
- **Financial shock:** either increases risks or reduces yields → a cycle of deleveraging → sharp reduction in bank lending as bank capital falls → economic slowdown → further reduction in credit supply
- Banks are more pro-cyclical when they operate in more arm's length financial systems rather than through traditional relationship-based activities



How is crisis unfolding in Asia?

- China: growth rate slowed due to slowing exports
- India: growth rate slowed due to weakening investment
- ASEAN: economic activity has decelerated due to surge in food and fuel prices
- Financial markets have weakened due to pessimistic global outlook
- Current accounts showing strains due to rising import bills for commodities and slowing export growth
- CPI inflation soared in many countries in the first half of 2008
- Policy dilemma: how to respond to weakening growth outlook and global financial turbulence without overlooking the inflation risks



Finance, Growth and Poverty

- Results from Beck et al (2007):
 - Effects of financial development on poverty through two channels: aggregate growth, and changes in income distribution
 - Greater financial development is associated with poverty reduction
 - 60% of impact of financial development on the poorest quintile works through aggregate growth, 40% through reduction in income inequality
- Results from Claessens and Feijen (2006):
 - Private credit → productivity enhancing inputs or machinery → agricultural productivity → reduction in undernourishment or hunger
 - Private credit has a large negative effect on undernourishment through higher agricultural productivity (crop, livestock yields)
 - Distribution of banking outlets makes a difference



Impact of microfinance on poverty

- Allows poor people to protect, diversify and increase sources of income
- Mitigates vulnerability to extreme fluctuations and smooth out consumption
- SHARE clients, India: ¾ improved their well-being and half exited from poverty
- BRI clients, Indonesia: average income increased by 112% and 90% moved out of poverty
- MF clients in Bangladesh had better nutrition, health practices and health outcomes
- 68% of women members in Nepal were making decisions on buying and selling property, sending daughters to school



How sensitive is demand for credit to interest rate?

- Most microfinance interest rates range between 30-60%/year
- View: poor households primarily seek access to credit and not necessarily cheap credit
- Reason 1: since the poor are starved of capital, they are likely to have higher returns and can afford to pay higher interest rates
- Reason 2: since they already pay interest rates in excess of 100% per annum, raising rates >50% will not affect demand
- However, higher rates can exacerbate moral hazard and adverse selection, worsening loan repayments and screening out the most reliable borrowers
- Bangladesh study: demand for loans is not highly inelastic to interest rate changes ($e = -0.73$ to -1.04)
- Although financial stability was achieved, it came at a cost in terms of serving the bank's poorest clients (Dehejia 2005)



Impact of financial crisis on microfinance

- Will the current financial crisis be different from the 1997 Asian financial crisis in terms of impact?
 - Microfinance now more linked to domestic and international financial markets → effects greater, complex, unpredictable
 - However, countries have instituted better regulation and supervision
- Evidence of impact mostly anecdotal
- Not easy to separate the effects of the financial crisis, food crisis, etc.
- Rising food prices → savings withdrawal, reduced spending on non-food items, difficulty in loan repayments → liquidity and credit risks for MFIs (CGAP Survey 2008)
- However, the Symbiotics 50 benchmark, as of 4th Quarter 2008, denotes no major changes in terms of MFI profitability or risk



Impact of financial crisis on microfinance

Main Concerns

- Global liquidity crunch will affect the cost and availability of funding to MFIs, especially non-deposit taking ones
- Anticipating funding shortage, MFIs will slow growth and reduce new lending
- Loan portfolio of MFIs may shift in favour of wealthier clients
- Rural credit flow may diminish with major implications for the rural poor
- Borrowers will default on loans fearing no new loans
- MFIs borrowing in foreign currency face both interest rate increases and currency depreciation



IFAD Study on impact of financial crisis in Asia

Objective

- To analyse relationship between finance, growth, poverty and hunger in selected Asian countries (Bangladesh, China, India, Indonesia, Malaysia, Pakistan, Philippines, Thailand, Vietnam)

Data

- Analysis based on panel of 9 countries over 1960 to 2006
- Source of data: WDI, FAO, UNU-WIDER



IFAD Study on impact of financial crisis in Asia

Methodology

- Four separate models estimated with dependent variables: GDP per capita or agricultural value added per capita, finance, inequality, under-nourishment
- Three definitions of finance: private credit, private credit through banks, financial system deposits
- Explanatory variables: CPI, govt expenditure over GDP (to measure size of govt), trade as a share of GDP (measure of openness), FDI as a share of GDP (measure of degree of openness), share of population with > primary education



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- Mixed results depending on model specification and variables
- Some evidence favouring a positive role of finance on GDP and agricultural value added growth
- Also evidence of reverse causality between GDP and agricultural growth on financial development (few cases in which causality runs both ways)
- Results on inequality and hunger require cautious interpretation
- Financial development reduces Gini coefficient of income distribution



IFAD Study on impact of financial crisis in Asia

- It does not have any effect if inequality is defined in terms of share of the poorest quintile in GDP → presumably due to the exclusion of the poorest in the sample countries
- Financial development reduces hunger but results not robust
- Higher interest rates and lower maturity periods likely to affect women and low-income HHs more
- Quality of loan portfolio of MFIs may deteriorate with higher interest rates and drying up of funding sources
- Contraction of credit and risk aversion of investors, together with looming global recession will adversely affect the poor



Policy Implications and Responses

- Need to inject capital into rural financial sector → some response by national and international agencies
- Individual-based MFIs more profitable but proportion of poor and women borrowers lower than group-based institutions
- Interest rates > threshold → worsening of portfolio quality → screening & monitoring by peers in group-based systems helps to overcome problems of moral hazard and adverse selection
- When individual-based MFIs grow larger, they focus on wealthier clients (mission drift) → design matters



Policy Implications and Responses

- Alterations in the design of microfinance programmes (e.g. longer maturities, larger loan amounts, appropriate pricing of loans)
- Policy makers should ensure that short-term measures (e.g. loan forgiveness, subsidized lending, interest rate cap) do not diminish long-term access to sustainable financial services
- Crisis as an opportunity: new products, better risk management