GLOBAL RECESSION
&
IT'S IMPACT ON INDIA / DEVELOPING COUNTRIES

INTRODUCTION

The fear of a recession looms over the United States. And as the cliché goes, whenever the US sneezes, the world catches a cold. This is evident from the way the Indian markets crashed taking a cue from a probable recession in the US and a global economic slowdown. Weakening of the American economy is bad news, not just for India, but for the rest of the world too.

A recession is a decline in a country's gross domestic product (GDP) growth for two or more consecutive quarters of a year. A recession is also preceded by several quarters of slowing down.

An economy which grows over a period of time tends to slow down the growth as a part of the normal economic cycle. An economy typically expands for 6-10 years and tends to go into a recession for about six months to 2 years.

A recession normally takes place when consumers lose confidence in the growth of the economy and spend less. This leads to a decreased demand for goods and services, which in turn leads to a decrease in production, lay-offs and a sharp rise in unemployment. Investors spend less as they fear stocks values will fall and thus stock markets fall on negative sentiment.

STOCK MARKETS & RECESSION

The economy and the stock market are closely related. The stock markets reflect the buoyancy of the economy. In the US, a recession is yet to be declared by the Bureau of Economic Analysis, but investors are worried a lot. The Indian stock markets also crashed due to a slowdown in the US economy.

The Sensex crashed by nearly 13 per cent in just two trading sessions in January. The markets bounced back after the US Fed cut interest rates. However, stock prices are now at a low ebb in India with little cheer coming to investors.

SUB-PRIME MARKET CRASH

In July 2007, niggling delinquency problems started to crop up in one tiny corner of the U.S. 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 havoc 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 tightened credit in most of the world's major financial centers. This has set off worldwide concerns about the

resulting credit crunch and a looming U.S. financial crisis that has led to a global recession, hurting also the real economy.

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.

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?

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.

IMPACT OF RECESSION ON DEVELOPING COUNTRIES

The channels of impact of recession on developing countries include:

- **Trade and trade prices:** Growth in China and India has increased imports and pushed up the demand for copper, oil and other natural resources, which has led to greater exports and higher prices, including from African countries. Eventually, growth in China and India is likely to slow down, which will have knock on effects on other poorer countries.

- **Remittances:** Remittances to developing countries will decline. There will be fewer economic migrants coming to developed countries when they are in a recession, so fewer remittances and also probably lower volumes of remittances per migrant.

- **Foreign direct investment (FDI) and equity investment:** These will come under pressure. While 2007 was a record year for FDI to developing countires, equity finance is under pressure and corporate and project finance is already weakening. The proposed Xstrata takeover of a South African mining conglomerate was put on hold as the financing was harder due to the credit crunch. There are several other examples e.g. in India.

- **Commercial lending:** Banks under pressure in developed countries may not be able to lend as much as they have done in the past. Investors are, increasingly, factoring in the risk of some emerging market countries defaulting on their debt, following the financial collapse of Iceland. This would limit investment in such countries as Argentina, Iceland, Pakistan and Ukraine.

- **Aid:** Aid budgets are under pressure because of debt problems and weak fiscal positions, e.g. in the UK and other European countries and in the USA. While the promises of increased aid at the Gleneagles summit in 2005 were already off track just three years later, aid budgets are now likely to be under increased pressure.

- **Other official flows:** Capital adequacy ratios of development finance institutions will be under pressure. However these have been relatively high recently, so there is scope for taking on more risks.

COUNTRIES AT RISK

The list of channels above suggests that the following types of countries are most likely to be at risk (this is a selection of indicators):

- Countries with significant exports to crisis affected countries such as the USA and EU countries (either directly or indirectly). Mexico is a good example;

- Countries exporting products whose prices are affected or products with high income elasticities. Zambia would eventually be hit by lower copper prices, and the tourism sector in Caribbean and African countries will be hit;

- Countries dependent on remittances. With fewer bonuses, Indian workers in the city of London, for example, will have less to remit. There will be fewer migrants coming into the UK and other developed countries, where attitudes might harden and job opportunities become more scarce;

➢ Countries heavily dependent on FDI, portfolio and DFI finance to address their current account problems (e.g. South Africa cannot afford to reduce its interest rate, and it has already missed some important FDI deals);

➢ Countries with sophisticated stock markets and banking sectors with weakly regulated markets for securities;

➢ Countries with a high current account deficit with pressures on exchange rates and inflation rates. South Africa cannot afford to reduce interest rates as it needs to attract investment to address its current account deficit. India has seen a devaluation as well as high inflation. Import values in other countries have already weakened the current account;

➢ Countries with high government deficits. For example, India has a weak fiscal position which means that they cannot put schemes in place;

➢ Countries dependent on aid.

While the effects will vary from country to country, the economic impacts could include:

➢ Weaker export revenues;

➢ Further pressures on current accounts and balance of payment;

➢ Lower investment and growth rates;

➢ Lost employment.

There could also be social effects:

➢ Lower growth translating into higher poverty;

➢ More crime, weaker health systems and even more difficulties meeting the Millennium Development Goals.

IMPACT OF RECESSION ON INDIA

Indian companies have major outsourcing deals from the US. India's exports to the US have also grown substantially over the years. The India economy is likely to lose between 1 to 2 percentage points in GDP growth in the next fiscal year. Indian companies with big tickets deals in the US would see their profit margins shrinking.

The worries for exporters will grow as rupee strengthens further against the dollar. But experts note that the long-term prospects for India are stable. A weak dollar could bring more foreign money to Indian markets. Oil may get cheaper brining down inflation. A recession could bring down oil prices to $70.

The whole of Asia would be hit by a recession as it depends on the US economy. Even though domestic demand and diversification of trade in the Asian region will partly counter any drop in the US demand, one simply can't escape a downturn in the world's largest economy. The US economy accounts for 30 per cent of the world's GDP.

Says Sudip Bandyopadhyay, director and CEO, Reliance Money: "In the globalised world, complete decoupling is impossible. But India may remain relatively less affected by adverse global events." In fact, many small and medium companies have already started developing trade ties with China and European countries to ward off big losses.

Manish Sonthalia, head, equity, Motilal Oswal Securities, says if the US economy contracts much more than anticipated, the whole world's GDP growth-which is estimated at 3.7 per cent by the IMF-will contract, and India would be no exception.

The only silver lining is that the recession will happen slowly, probably in six months or so. As of now, IT and IT-enabled services, textiles, jewellery, handicrafts and leather segments will suffer losses because of their trade link. Certain sections of commodities could face sharp impact due to the volatile nature of these sectors. C.J. George, managing director, Geojit Financial Services, says profits of lots of re-export firms may be affected. Countries like China import commodities from India, do some value-addition and then export them to the US.

The IT sector will be the worst hit as 75 per cent of its revenues come from the US. Low demand for services may force most Indian Fortune 500 companies to slash their IT budgets. Zinnov Consulting, a research and offshore advisory, says that besides companies from ITeS and BPO, automotive components will be affected. During a full recession, U.S companies in health care, financial services and all consumers demand driven firms are likely to cut down on their spending. Among other sectors, manufacturing and financial institutions are moderately vulnerable. If the service sector takes a serious hit, India may have to revise its GDP to about 8 to 8.5 per cent or even less.

Lokendra Tomar, senior vice-president, Integreon, a BPO firm, says the US recession is likely to have a dual impact on the outsourcing industry. Appreciating rupee along with poor performance of US companies (law firms, investment banks and media houses) will affect the bottom line of the outsourcing industry. Small BPOs, which are operating at a net margin of 7-8 per cent, will find it difficult to survive.

According to Dharmakirti Joshi, director and principal economist of CRISIL, along and severe recession will seriously affect the portfolio and fixed investment flows. Corporate will also suffer from volatility in foreign exchange rates. The export sector will have to devise new strategies to enhance productivity.

COUNTER STRATEGY

Karthik Ananth, senior consultant, business development, Zinnov, says there is already a shift in business strategies of corporate India. Large IT and BPO firms have started looking at other markets like Europe, and even the domestic market, to spread their risks and reduce the impact of the rising rupee. This can be best seen with Infosys setting up an India centric team.

K. Ramachandran, head, advisory desk, BNP Paribas Private Banking, says Indian companies will have to adopt a multi-pronged strategy, which includes diversification of the export markets, improving internal efficiencies to maintain cost competitiveness in a tight export market situation and moving the product portfolio up in the value chain to impart resilience.

The IT sector too is keen to defend its position. R.S. Rethinasamy, vice-president, Finance Aditi Technologies, says that in case of a full-blown US recession, the onsite staffing business will see a decline in sales and profit. "At the same time, it can increase the offshore work. Recessions at this juncture may not last for more than two to three years. Smart companies will continue to make investments so that they can be ahead of the competition when the US economy comes out of recession", he says.

This means corporate India will have to spend a lot more to develop market and supply chain links in alternate markets like Asia and Europe. Experts say the export dependent sectors of the economy need to re-focus on local demand and income from non-dollar economies.

The European, West Asian and the African countries may offer viable short-term alternatives to our export-dependent sectors. BPOs, for example, will have to re-negotiate with their clients and fix appropriate price for their services.

Can India be a market option? Zinnov says IT firms can definitely find a market in India, but the deal sizes are likely to be small. India has a huge, small and medium enterprise base and it is the right time to tap this segment. As for automotive components, consumer electronics and mobile devices, they have already found a market in India and have also started looking at tie-ups in China and other BRIC countries.

CONSEQUENCES OF RECESSION ON INDIA JOB MARKET

Worst affected because of US recession will be the service industry of India. Under service industries come BPO, KPO, IT, ITeS etc. Service industry contributes about 52% to India's GDP growth. Now if that is going to get hurt then it will also hurt India's overall growth but very slightly. India is not going to face a major impact due to US recession. People may say that there is going to be a huge job loss due to recession. and will cite the example of TCS firing about 500 employees but these were employees who didn’t perform and for cost cutting one have to reduce Non performing asset and that exactly what has been done. There is no threat to the skilled people. According to NASSCOM India will have a shortage of about 5 million skilled people in IT/ITeS. So there are lots of opportunities.

Apart from this India's travel, tourism and power industry is going to grow at a better rate. This is again a good sign. India has a huge population so a huge consumer base so we don’t have to always depend on US for our growth. India's GDP is expected to grow at the rate of 8.5-8.9 % which is again way above the growth rate of US and only second highest in the world after China.

This recession gives us opportunity to be innovative and to think out of box so that the US directly doesn’t affect our robust growth. Due to increasing Rupee exporters are having a hard time but it has been noted that our exporters are not that efficient and in past they got the benefit of depreciating rupee. So now its time to be innovative and more effective and increase the over all efficiency and go for systematic cost cutting to balance the rupee effect. In fact there are lots of scopes for improvement. In West Africa goods at departmental stores are sold at the rate 5 times than Indian price and Indian goods are not exported to several countries in West Africa. It’s an excellent opportunity for our exporters.

THE IMPACT OF GLOBAL RECESSION ON THE BANKING SYSTEM

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 trade - and also developing countries exports - declines 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 Dr. 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 our analysis we might just concentrate at first on the distinction between countries with or without natural resources and between big exporters of manufacturing 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 devaluating 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 emergency18, 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 American 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.

According to the World Bank (2008), 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 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.

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 financial markets of underdeveloped countries are - whenever existent - typically weakly integrated, so softening 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. 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. 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 inter-bank 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, 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.

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.

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"

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.

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.

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. 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.

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.

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.

THE IMPACT OF RECESSION ON MICROFINANCE RISK

MFIs operating in developing countries are bound to face some impact during the ongoing global recession despite profiting from the double safety. 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 different types of risks associated with MFIs and their behavior during the recession period are discussed below:

- **Country risk:** The likelihood that changes in the business environment will adversely affect operating profits or the value of assets in a specific country. Country risk includes the threat of currency inconvertibility, expropriation of assets, currency controls, devaluation or regulatory changes, institutional corruption or instability factors such as mass riots, civil war and other potential events. Failing states with bad policies and governance, especially if landlocked by bad neighbors, unsurprisingly have a higher and persistent country risk

Recession brings to a domino effect of country risk and credit default swaps on Government Bonds show higher premium, since governments who rescue banks and companies increasing their public debt become riskier. Country risk grows in most Western countries more than it does in developing areas, but this does not bring to an automatic flow of funds from the former to the latter. Successful MFIs show flexibility and resilience from economic volatility and since MFIs are not strongly correlated to the country's GDP and macroeconomic situation, they are most likely to experience less country risk which is affected by recession.

- **Political risk**: Closely linked to country risk, political risk is a consequence of the complications that businesses and governments may face as a result of what are commonly referred to as political decisions or any political change that alters the expected outcome and value of a given economic action by changing the probability of achieving business objectives. This is the risk of a strategic, financial, or personnel loss for a firm because of such non-market factors as macroeconomic and social policies (fiscal, monetary, trade,

investment, industrial, income, labour, and developmental) or events related to political instability (terrorism, riots, coups, civil war, and insurrection)

Political risk is most likely to increase during a recession and MFIs are always affected by the political crisis in a country. However unregulated MFIs are less correlated to macroeconomic policies and therefore suffer less political risk.

- **Foreign exchange risk**: The risk of losses due to unstable currency exchange rates and adverse changes, such as devaluation of the local currency (if debt is denominated in reevaluating hard and foreign currencies). MFIs face foreign exchange risk only to the extent that debt is denominated in hard foreign currencies, this hardly ever being the case in small institutions.

Weak currencies are likely to devaluate against harder currencies and recession might speed up this process, if local inflation is higher and country risk worsens. Credit crunch deriving from recession and bank crises dries up foreign funds, so limiting new sources of risk.

- **Financial Market risk:** The risk that the financial conditions will be adversely affected by the changes in market prices or interest rates, foreign exchange rates and equity prices.

During a recession, market risk for MFIs remains low as they are less dependent on the international (and domestic, if they are not in the upper Tier ranking) capital markets.

Institutional risk (due for example to Central banking or stock market regulations) can be a consequence of overreaction to the crisis by policymakers, with regulation becoming more conservative (about new licenses for deposit taking, capital requirements or branch expansion); this is good for quality and sustainability, but not for growth and outreach.

- **Interest rate risk**: The risk that changes in interest rates might affect operating and net margins of the MFI. Interest rates increases raise the cost of collected capital and are not always transmittable to more expensive loans, since borrowers might be unable to pay higher rates and their default risk might increase.

During a recession, basic interest rates (fixed by central banks or within inter-bank loans) normally decrease, since inflation is typically cooled down by limited pressures on prices. Risk premiums conversely tend to increase, due to a general higher default risk. The net effect often brings to an overall increase of interest rates and, consequently, to a higher risk of non - repayment from borrowers.

- **Corporate governance risk**: Corporate governance sets the rules of cohabitation and the behavior of the different stakeholders that pivot around the MFIs (borrowers, lenders, shareholders, supervisory authorities …). Typical banking and specific microfinance risks include adverse selection (the difficulty to discriminate between good and non trustworthy borrowers), moral hazard (the "take the money and run" option) and strategic bankruptcy (false information that the borrower gives about the outcome of the financed investment, to elude repayment) . Information asymmetries are also part of the game. Corporate governance is also concerned with legal and compliance risk, which involves losses arising from failure to follow relevant legal and regulatory requirements. In unregulated MFIs, the risk - if existent - is low but even the benefits of regulation and good governance is missing.

Corporate governance risk might increase in recession, when the banking system often becomes indiscriminately mistrustful against actual or potential borrowers and otherwise strategic bankruptcies might become effective.

Relationship lending and continuous monitoring of unsophisticated and small borrowers reduces the risk of information asymmetries in MFIs, if compared with mainstream banks.

When life becomes more complicated, simplicity pays.

- **Credit (repayment or delinquency) risk**: Credit risk applies to lending and investing activities and it considers the risk of financial losses resulting from borrowers' delay or nonpayment of loan obligations. MFIs are institutionally more directly concerned about risk than other Western financial institutions, such as mainstream banks or - even more - hedge funds and other sophisticated and not-so-transparent intermediaries or products. Since repayment installments are weekly or monthly for MF clients, and the loan amounts are small, credit risk is typically lower than in normal banks.

Credit risk is likely to grow during recession due to increased cost of capital (higher interest rates) higher repayment difficulties and probabilities of default. If MFIs are increasingly unable to meet the borrowers' needs, then eagerness to repay debt might decrease and opportunistic behavior might increase. Additional clients might be marginally less trustworthy. Repayment rates might fall off during recessiony. Remittances from Western countries consistently slow down, to the detriment of the poor relatives indebted with local MFIs. Emergency consumption dries up savings, so eroding guarantees and ability to match obligation from the poorest.

- **Competition risk**: Commercial banks have started downscaling in order to access the microfinance market. The informal sector (money lenders) is most likely to provide a stiff competition to microfinance as it's not affected by the economic turmoil.

Competition typically grows in recession, eroding margins, since the market is shrinking and the players become more aggressive, struggling for survival.

- **Strategic risk**: The risk to earnings or capital arising from adverse business decisions or improper implementation of strategies, due to mismanagement or organization fallouts. Reliable strategic goals, development of proper business actions and deployment of adequate resources and the quality of management reduce the risk.

Strategic risk increases in recession as targets are more difficult to be reached. Mission drift might be a consequence of high strategic risk and subsequent fight for survival.

- **Inflation risk:** Probability of loss resulting from erosion of an income or in the value of assets due to the rising costs of goods and services. The possibility that the value of assets or income will decrease as inflation shrinks the purchasing power of a currency. Surge in inflation levels might bring to deposits withdrawals for survival needs.

The growth of food prices, now finished but still painful, has increased inflation and caused recessive problems in poor countries. In recession, inflation risk might decrease, since price pressure and salary expectations cool down, unless there is a particular stagflation scenario. Extreme commodity and oil price volatility can increase inflation.

- **Liquidity risk:** The risk of losses that arise from the possibility that the MFIs may not have sufficient funds to meet their obligations or be unable to access adequate funding.

During recession, funding is most likely to squeeze as donors hold back their subsidies and due to increased interest rates on the capital markets, MFIs will reduce acquisition of more debt financing. However MFIs should mobilize other sources of funding in form of local savings and local debt. If MFIs are linked with ailing banks, their liquidity investments in both directions might be halted and interest rates in the interbank market grow. Money is scarcer and more expensive to get.

Liquidity constraints increase risk and might also have unfavourable pro-cyclical 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.

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 off 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.

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. 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 microfinance financing from both local and foreign investors, 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. 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. 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 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. 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.

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.

Experience and research has 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%. MacInnis of Reuters observed that "Charitable giving and foreign aid flows are likely to dry up as the global economy sours."

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.

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

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 subsidises 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 unable 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 a 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 subsidises (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 act 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 spill 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 harbour for MFIs, because as global economic conditions continue to worsen, microeconomic 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.

CONCLUSION

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

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.

Refinancing risk is – in such a scenario – the key question, especially for bigger and more sophisticated MFIs, if mostly funded from external sources (direct foreign investments, MIVs, international financial institutions and aid agencies) or for smaller donor and NGO driven MFIs.

Direct access to capital markets is rare - albeit growing - for MFIs, sheltering them from the financial crisis in the short term but preventing them from the use of cheaper sources of finance when the general economic outlook improves. Deposits might be withdrawn when inflation is surging, due to survival needs, as we have seen in the recent food and oil price peaks, but recession normally cools prices down. Other forms of funding might prove harder for MFIs, especially if the credit crunch continues.

Lower growth might have a stability impact for current and new borrowers, making debt more expensive for the former and often unavailable to the latter: a threat for sustainability of MFIs but an even more lethal problem for outreach.

Transformation of small and donor driven NGOs to institutional deposit collecting MFIs needs grant money from the donors and then cash from depositors, banking institutions and - eventually - the financial market, but funding is increasingly difficult and more expensive in any of these passages.

As in previous crises, there might be an increased financial system consolidation around stronger players even in emerging countries. If this trend affects also MFIs, the thousands of small MFIs might merge into greater entities or simply disappear, following a Darwinian selection where only the strongest survive; there is however some doubt that the bigger are automatically the better, this not being the case in many Western banks affected by the crisis or in some MFIs strongly dependant on foreign funds.

Recipes for the present and lessons for the future are highly wanted and they include some wise suggestions:

➢ 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, immune of currency risk and more synchronized with local loans 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;

➢ 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.

For India, it could mean a further appreciation in the rupee vis-à-vis the US dollar and a darkening of business outlook for sectors dependent on US companies. The overall impact of a US slowdown on India would, however, be minimal as the factors driving growth here are more local in nature. Unlike the rest of Asia, India is a strong domestic demand story, so any slowing in the US is likely to have a more muted impact on India. Strong growth in domestic consumption and significant spending on infrastructure are the two pillars of India's growth story. No sector has a dominant influence on earnings growth and risks to our estimate are limited. Corporate India is also learning to master the art of efficient capital management, reduction in costs and delivery of value-added services to sustain profit margins. Further, interest rates are expected to be stable primarily due to control over inflation and proactive measures undertaken by the RBI.

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