

The Impact of Inflation on Microfinance Clients and its Implications for Microfinance

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Introduction

As the inflation rate in Pakistan crosses 25 percent per annum — the highest in almost three decades — there is justifiable concern that the Pakistani citizen, particularly the poor, will suffer the most and will bear the severest brunt of this economic crisis. Moreover, along with rising prices, indications suggest that Pakistan's economy is also facing serious constraints and the high growth rates between 2002 – 2007 may have slowed down considerably, affecting economic opportunities for all, but particularly for the poor. Pakistan Microfinance Network in Islamabad has commissioned this study in order to understand and document the impact of a slowing economy and in particular, of rising inflation on microfinance clients.

This short report highlights findings based on discussions with 245 microfinance clients, both men and women, from very wide and diverse backgrounds, and with the staff of microfinance providers (such as loan or credit officers) who interact with these clients at the local, first contact, level and are far more aware about the conditions of their clients than are middle and senior management officers. It is important to state at the outset that this study is not an overview or assessment of the microfinance sector, of microfinance clients, or of microfinance institutions or providers. It has considerably limited ambitions and objectives and simply aims to understand and document the impact of inflation on microfinance clients and, to a limited extent, for microfinance practitioners.

Inflation and its Consequences

Inflation is the phenomenon where prices rise. Hence, inflation is not at all an uncommon feature of any economy. In fact, low or manageable levels of inflation — depending on the nature of the economy — are highly beneficial to suppliers and producers and act as an incentive to produce.

Inflation affects different segments of the population very differently, a fact often forgotten by most people and often exaggerated or misrepresented in the media. In general, inflation affects the rich far less than the poor, where the rich hold greater assets and have higher incomes which let them adjust to rising prices. Salaried individuals tend to be affected a great deal by inflation as their salaries tend to be 'sticky' and often do not rise in proportion to inflation or at the same speed. In contrast to salaried individuals, inflation affects many categories of producers in a neutral manner or can benefit them. For example, to maintain their profit margins, many producers pass on all price increases as they take place. Based on the elasticity of demand for their product or service this may result in higher or lower profits, or no change. Inflation, in 'traditional' or agricultural societies, is considered to be an urban phenomenon far more than it is a rural one based on assumptions such as rural populations produce a great deal of what they consume, and that they have less access to 'modern' facilities, commodities and goods (such as consumer items and utilities), the price for which often rise fastest. Similarly, there is also a marked difference on savers and borrowers, which has implications for this study and on microfinance clients more generally. Savers suffer as the purchasing power of their monetary assets dwindle in value, whereas those who have borrowed benefit as inflation rises, since the real value of their debt is reduced.

Just as we assume that many citizens will suffer the consequences of inflation, we should also be open to the possibility that some sections of the population will benefit from rising prices. This study tries to highlight where and how both trends persist amongst microfinance clients.

The Pakistan Context: Inflation, the Economy and Microfinance

Before we turn to describe how this study was conducted, it is important to highlight some of the issues which relate to Pakistan's inflation rate, its economy, and the microfinance sector.

Like much of South Asia, inflation has seldom been a serious problem in Pakistan, and the inflation rate has been, for the most part, in single digits. However, for about a year, but perhaps more markedly since early 2008, the inflation rate in Pakistan has become the highest in over three decades, and has shot up dramatically from the annual 9 percent in fiscal year 2007 – 2008, to between 23 – 28 percent on an annualised basis today, with food and fuel prices driving the price spiral.

While inflation has been perhaps the most visible of Pakistan's economic problems in the last few months, economic slowdown, as illustrated by falling levels of investment and slowing economic growth, have been equally troubling. The high growth period of 2002 – 2007, in which growth averaged over 6 percent of GDP per annum, has been replaced with a forecast for financial year 2008 – 2009, which could be nearer 4 percent of GDP growth. Similarly, there are predictions that a slowing economy and high inflation may raise the unemployment level in Pakistan. Most economists agree that economic activity, at least for the next year or so, will be well below the level of the last five years, affecting profitability, investment, employment and the poverty level. There are concerns that the dual problem of rising inflation and a slowing economy will push more people below the poverty line.

There are reported to be 1.8 million microfinance clients in Pakistan, which represent different arrangements of loans — group, individual, etc. Of these, a great majority are rural clients, which has important implications for how inflation has an impact on them. Almost half of microfinance clients are women. Often, the average profile of a microfinance client in Pakistan is that she is either a rural entrepreneur, involved in livestock development or passes on her loan to a male member of her family. Also, importantly, it seems that a very large majority of microfinance clients are repeat clients and once they begin to use microfinance services, the majority of clients stay loyal to the microfinance provider. These characteristics of microfinance clients will help determine how inflation affects them.

Methodology

This study to assess and observe — but not to measure — the impact of inflation on microfinance clients, is built around the Focus Group Discussion (FGD) approach. Despite its many limitations, this approach allows us to draw broad conclusions about the impact of inflation on microfinance clients.

A selection was made of different sorts of microfinance providers. In all, nine institutions were selected in three provinces and 12 FGDs were held. In total, 245 clients were present at the FGD of which 189 (77 percent) were women.

The FGDs were used to understand how inflation had an impact on borrowers and how they were coping under inflationary pressures. Questions were asked to find out if clients were having problems repaying their monthly instalments, whether their economic activity had fallen, and how this affected their household consumption. Information was acquired to see if household consumption patterns had changed in the last year or so as prices had risen. There was also discussion on how clients were prioritizing loan instalments in relation to other household expenses in this inflationary environment compared to the past. The issue of inflation was not initiated as it was thought it would be better for clients to volunteer information and opinions about their concerns themselves and to prioritise their own issues, of which inflation ought to have been one. If it was not raised by the discussion participants, specific questions on inflation were put to them.

Discussions were held with loan officers and MFP management to assess whether they saw any changes in borrowers' behaviour and their demand for loans and repayments.

Findings from Focus Group Discussions

The results from the discussion with microfinance clients regarding the impact of inflation on their incomes, assets and repayment capabilities, come as a complete surprise. Our assumption was, as it is of most people, that the high inflation rate in Pakistan has been a disaster for most Pakistanis. However, a predominant majority of clients who spoke, irrespective of gender, location, type of activity, amount and purpose of loan, or by any other criteria, *was that inflation was 'not a problem'*. While almost every single participant in the 12 FGDs felt that the loans were in general

highly beneficial to them and to their economic activities, except for a very small minority, most felt that inflation was not resulting in them having a significantly negative impact on their businesses or lives. In fact, there were a large number of clients who felt that inflation was a positive aspect and that they were capturing higher profits on account of the price rises. Overall, one can safely conclude that on the basis of the FGDs, it was clear that a huge majority felt that inflation had a neutral influence on them, while a substantial proportion of the clients felt that inflation was substantially beneficial.

The explanations of these unexpected findings were given by the clients themselves. Many felt that in their line of business, it was easy to pass-on costs which were imposed on them and were able to argue how the loan had made it easier for them to deal with inflation. Moreover, there were certain clients who confessed that they were passing-on larger amounts of the rise in their costs and were also 'causing' inflation. It has to be remembered, that all these clients had been given loans in the past and were now repaying the instalments. Hence, inflation for them was a relatively more recent phenomenon and took place largely after they had made use of their loan. Many urban clients, such as those who had shops or small outlets, all felt that a lump sum loan allows them to buy goods in bulk and stock-up. All those clients who had taken a loan to buy stocks in the past had done so and were now able not just to pass-on prices, but also to increase the prices of goods that were cheaper earlier.

For the most part, in urban areas, with the exception of men in Orangi (more below) most clients, such as women who ran beauty parlours in neighbourhoods or women who were in the small business of making jewellery or clothes, all claimed to pass-on at least the full impact of inflation, and hence neutralise the impact of inflation on them. On being asked if their clientele had declined or their profits denuded on account of higher prices for the goods and services they provided, most said that they had not.

There was also a general understanding about the inflation phenomenon in Pakistan by almost all clients. A repeated answer to how these clients, all across Pakistan, had become immune to inflation and neutralised its impact was that they were all using their loans for productive purposes rather than for consumption needs, and hence would be able to recoup their investment. Most clients even realised that the instalments they were paying back every month were declining in real value due to inflation.

Not a single client complained that they were unable to repay their instalments.

Moreover, two further explanations were given as to how in times of high inflation — and every single client was cognisant of the fact that these were such times — managed to make profits, were as follows. Firstly, clients stated repeatedly that they were working much harder than they had in the past. The second explanation of how they were dealing with inflation was that they would include more members from their household in their economic activity if they could. In general, many clients said that there were also more earners in their family and this was helping them through these times. Additionally, most clients stated that they were no longer able to maintain any savings.

Without doubt, the greatest beneficiaries of inflation were agricultural producers and rural dwellers, the latter representing the majority of clients in the microfinance sector in Pakistan. Those who grew some agricultural crop were benefiting from the higher crop prices and said that they had made many times the income they anticipated. As microfinance clients they stated that the lump sum loan amount had allowed them to purchase inputs for their land in bulk some months ago, and hence cheaply, and now they were enjoying the double benefits of higher support prices for key food crops and for cotton. It seems that many farmers would have benefited from the higher output prices of agricultural products, but the advantage of microfinance clients would be that they could use the loan to purchase inputs in bulk and more cheaply. While many farmers borrowed from numerous sources, it seems that those who borrowed from non-traditional, formal systems claimed that they were better off.

Another category in the rural and peri-urban sectors who said that they benefited markedly by the price rise were those who had taken loans for livestock, and particularly for buffaloes and milk production. At every FGD, clients claimed that the increase in the purchase price of raw milk had caused their incomes to grow very substantially. Similarly, flower producers in Pattoki also stated that while their input prices had risen slightly, the price they received for flowers in large urban centres like Islamabad and Lahore was considerably higher.

There were a very small minority who stated that inflation had made them worse off. Of these individuals, perhaps three or four had mentioned that they may have had to sell a household asset — like a mobile phone — because they could not afford it and

because they needed the money. There was just one single case of a woman who had said that she had to switch her child from a private school to a public school. But these examples were almost non-existent. However, all the seven clients of the Orangi Charitable Trust in Karachi stated that they were having great difficulty coping with repayments, not so much due to inflation, but because of economic slowdown. These clients were all involved in the loom/textile sector, a sector which has suffered a great deal in recent years, and it was clear that they were struggling. For the most part, inflation, per se, was not seen as the main culprit.

Discussions with loan and credit officers about whether it had become particularly difficult for clients to make the instalment repayments, suggested that there had been some change, but not a great deal. In the case of Karachi, it was clear that loan officers for the Orangi Charitable Trust had to make extra visits and accommodate clients. Officers in other microfinance institutions did not state that the default rate had risen and few stated that they had significant problems.

To end this section, one can state that inflation, as such, did not have the negative outcome we thought it would. Many clients were using inflationary times to their advantage. Moreover, in urban areas, most people were complaining about the lack of electricity and power — and not its price — than they were of overall inflation. The table below summarizes the findings from the FGDs.

Is Inflation a Concern for Microfinance Clients?

Apparently, it seems, it is not. If we assume that most clients are accommodating inflation and even benefiting from it, is this a matter of concern? We believe it will be, and we try to answer the question posed as the title of this section.

There are a couple of reasons why inflation did not seem to be a problem for microfinance clients. The first and very probable explanation is that perhaps inflation has not really hit the clients or producers in general, in term of their profits and income stream. It is quite possible that the impact of inflation has not been fully passed through to these clients. If this is the case, then we can be quite sure that some months from now, if inflation continues, it will have a strong impact on the livelihoods of microfinance clients.

Another possible explanation is that the FGD format does not allow for a fair and honest depiction and representation of what is actually going on. Perhaps inflation is affecting clients quite severely but they are not expressing this concern. However, we feel, for the reasons given above, that this is unlikely to be the case. While it is true that the FGD format has limitations, it is improbable that it would have repressed sentiment to such an extent that observers would not have been able to probe further and get to the truth.

Table 1 Selected Impact of Inflation on Various Categories of Microfinance Clients

	Positive	Neutral	Negative	Uncertain
URBAN				
Shopkeepers	●	●		
Traders	●	●		
Small manufacturer	●	●		
Textile related business			●	
Fixed income business			●	
Livestock non-milk producers	●			
Milk producers	●			
RURAL				
Shopkeepers	●	●		
Traders	●	●		
Food crop producers	●			
Other cash crop producers	●			
Livestock non-milk producers	●			
Milk producers	●			
Household handicrafts		●	●	

What also emerged from the FGD was that most clients, realising that we are living in inflationary times, felt that the loan amounts made available were insignificant and were interested in inflation-indexed loans. However, many did also state that the instalment amounts should not be raised too significantly as this would make repayments difficult. For microfinance providers/institutions rather than clients, the concerns that will emerge in the future relate to delinquency, delayed payments and default. At the moment, it does not seem like these issues are threatening the functioning of institutions, but it is possible that they might put a strain on the profitability of some institutions. Also, it is very clear that if inflation stays at 20 – 25 percent, most microfinance providers will have to raise their credit levels to match the real value of the loans. Whether microfinance providers can do that will depend on their overall financial strength, access to funds and ability to respond innovatively.

Conclusions

If inflation has not had a damaging effect on microfinance clients in the first nine months of 2008 when inflation has touched 25 percent, as a very high majority of clients claim, it is very likely that it will have an effect some months from now if inflation continues to persist. However, if as expected, inflation begins to

fall and becomes more manageable, it seems that the concern for the impact of high inflation will no longer exist and that we will return to the situation of a few years ago. This short, illustrative study suggests that most clients have been able to deal with inflation and many, particularly those producing food crops and agricultural commodities, have actually profited a great deal from it. These conclusions come as a surprise, for conventional wisdom would have suggested that all citizens suffer the impact of inflation.

What emerges from this survey also, is the clear fact that loans have helped clients, largely because they have been able to buy cheap, or in bulk, and have been able to sell at the increased market price. Clearly, those who have access to credit are at an advantage compared to those who do not have access to credit at cheap rates. This has been the general principle of microfinance and it seems to have particular significance in the times of high inflation.

If inflation rates persist, some rethinking on the behalf of microfinance providers may be necessary. They might have to raise their credit ceilings keeping in mind the real value of the loan, and may be required to increase the loan instalment process by some months to ease the likely pressure on clients.