

MICROFINANCE:

THE NEWEST FINANCIAL TECHNOLOGY OF THE WASHINGTON CONSENSUS

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The leading global financial institutions have announced their newest model to govern global capitalism known variously as microfinance or banking the unbanked (CGAP 2006, IDB 2006, United Nations 2005). The effort will replace the post-cold war model, which encouraged governments of emerging markets to join the market system by opening economies to foreign capital, selling public assets, and pegging currencies to the U.S. dollar with the promise that global capitalism would help eliminate poverty.

The model yielded tremendous financial rewards for investors from 1993 to 2000. It also exposed numerous nations to the risks of global capitalism, including financial meltdowns and high-interest debt. When foreign governments started questioning the model, renegotiating in their best interest, and, in some cases, walking away from loans believed to be backbreaking, investors saw the loss of a major source of profits. Hence a newer model is in the making. Instead of working with governments of emerging markets, financiers want to conduct business directly with poor people around the globe. Some of the products being offered include bank accounts, credit cards, mortgages, and insurance. Once again, the promise is that by joining the global marketplace, the poor will be lifted out of poverty.

This article describes the two models and discusses some of the implications for potential users of microfinance technologies. Given the novelty of the experiment, more questions are posed than answered. It appears, however, that this initiative has the potential to be a powerful and significant next step in the development of global capitalism and bears examining in order to inform its design and implementation. The analysis also suggests that we may be seeing a new form of green washing or “charity washing” in the making, whereby commercial bankers can use microfinance as a selling point to command pricing premiums for their products and investments.

The Washington Consensus 1990s Model

The modern day story of global capitalism began in 1989 with the fall of the Berlin Wall. The cold war ended; free market capitalism won. A new set of rules of the game was put in place that targeted emerging markets (i.e., developing or third world countries). The institutions designing the rules were part of what is known in political and economic circles as the Washington Consensus, including Wall Street, Washington, and multilateral financial institutions (see Williamson 1999).

Leading the group was Federal Reserve chair Alan Greenspan who represented Wall Street and President Bill Clinton who represented Washington. The deal began with the president's pledge to bring down the \$3.5 trillion national debt through the now-famous deficit reduction plan of 1993, which resulted in a U.S. surplus of \$7 trillion by 2000. In return, Wall Street dropped long-term interest rates, freeing up an enormous amount of investment capital for banks (e.g., Citigroup, J. P. Morgan Chase, Merrill Lynch, Goldman Sachs) and multilateral institutions (e.g., International Monetary Fund [IMF], World Bank, Inter-American Development Bank [IDB]).

To be part of the Washington Consensus and receive direct foreign investments and loans, a nation had to adhere to the following prescription:

- liberalize trade
- eliminate budget deficits
- privatize state-owned enterprises
- open financial markets to foreign capital
- peg currencies to the U.S. dollar.

Nations were told that economic growth was the surest way to lift people out of poverty, reduce inflation, and increase wealth. The prescription was exported rapidly around the globe in the early 1990s, beginning in Mexico then Russia, Thailand, Southeast Asia, Turkey, Brazil, and Argentina (see Flynn 2002). By 2000, \$2 trillion was moving around the planet in electronic currency markets every 24 hours.

A host of factors thwarted good intentions and neoclassical economic theory, creating large scale, unexpected financial instabilities in emerging markets. Within a few years of nearly every nation joining the Washington Consensus, a financial meltdown occurred, requiring the governments to borrow ever greater sums of money to make debt payments at ever higher interest rates with stricter conditions. Monetary authorities, including the Federal Reserve and the U.S. Treasury, often stepped in to bail out investors for fear that one nation's financial collapse would spread to other nations. Thus, an asymmetry emerged whereby the leading private and institutional investors who were part of the Washington Consensus reaped tremendous profits while governments in emerging markets were left heavily indebted.

A critical turning point was in December of 2001, when Argentina – fearing a financial meltdown – walked away from \$132 billion in debt, marking the largest default in history. Rather than assuming additional loans from the IMF to service its debt, Argentina stopped making loan payments all together and asked for time to reconsider its options.

Without the influx of foreign capital, Argentines suffered from fiscal austerity, unemployment, and growing poverty for several years. In 2005, the government offered to pay 32 cents on every dollar of debt, noting that this was more than Enron shareholders received after the energy trader filed for bankruptcy in December of 2001. Argentina is slowly regaining its footing and now posts annual growth rates exceeding eight percent.

Other nations are taking note of Argentina's experience. Several Latin American, Asian, and Eastern European nations are stockpiling dollars to avert future crises. Some countries are bypassing traditional lending institutions in favor of bilateral or regional partnerships (e.g., Brazil and India, Gulf Cooperative Council). The IMF's outstanding credit dropped from \$104 billion in 2003 to \$28 billion in 2006, reflecting an increasing reluctance to do business with the Washington Consensus under the old rules of the game (Blustein 2006).

The Twenty-first-Century Model

Hence, the Washington Consensus is re-thinking the rules governing 21st century global capitalism. Having lost high-yielding loan portfolios with governments in emerging markets, new financial technologies are being marketed directly to poor people. The generic term for the newest financial technologies is "microfinance," which includes banking services (e.g., savings accounts, ATM cards, cell phone banking), loans (e.g., home mortgage, small business, consumer), and insurance policies (e.g., life, health, home).

In Latin America, the new initiative was formally launched by the Inter-American Development Bank at a gathering of the key players of the Washington Consensus in June of 2006 in Washington, DC. It was noted that in Latin America, there are roughly 360 million poor people who do not have access to financial services. While most of these people live on less than \$2 a day, together their purchasing power exceeds \$510 billion per year. IDB President Luis Alberto Moreno wants to tap into this market: "These people . . . are smart consumers and entrepreneurs who constantly look for goods and services that improve their quality of life at an attractive price. And the tragedy is that those goods and services are either not available or too expensive" (IDB 2006).

Moreno's sentiments echoed those of United Nations Secretary-General Kofi Annan at the opening ceremony of the 2005 International Year of Microcredit, "The stark reality is that most poor people in the world still lack access to sustainable financial services, whether it is savings, credit or insurance. The great challenge before us is to address the constraints that exclude people from full participation in the financial sector" (United Nations 2005).

The new microfinance model of the Washington Consensus is a way for international financiers to access a previously untapped market sector that offers both profitable and attractive financial margins. The rhetoric is that the approach will allow the poor to be part of the global market place, access consumer goods, and be lifted out of poverty. Below is a brief description of some of the financial products and services being marketed.

Savings Accounts

The first step is to encourage people in emerging markets to open savings accounts with commercial banks, a service currently availed by less than ten percent of low income households around the world (Women's World Banking 2005). Given that the poor have no money, family members who work in the United States will be encouraged to deposit remittances into their families' local bank accounts. The funds can be accessed using Automated Teller Machines (ATMs) for a fee. Some banks plan to offer starter savings accounts that require small initial sums of money (e.g., \$25) and low minimum balances (e.g., \$ 10 a month) to attract new customers.

The World Bank (2006) estimates that \$167 billion in remittances was transmitted from migrants to their families in the developing world in 2005, only half of which was sent through the formal banking system. For some, commercial bank accounts could become a safe and easy way to send money home. It may also protect people from illegal, dangerous and/or expensive money-transfer systems in some parts of the world.

Currently, the most common way to send remittances is through money-transfer companies that charge a wiring fee of \$10 to \$30 per transfer (plus exchange-rate charges). The largest transfer companies are First Data Corporation, Western Union, and MoneyGram International with outlets throughout the world. Smaller transfer companies are often immigrant-owned businesses that rely on personal connections to see that the funds reach the intended recipient. Transmitters are required to register with the U.S. government's Financial Crimes Enforcement Network (FinCEN) and to pay state licensing fees.

The USA Patriot Act of 2001 paved the way for commercial banks to assume the primary role of global money-transmitting. The Act allows banks to demand detailed information about customers of money-transfer companies many of whom are illegally working in the U.S. and reluctant to share personal data. Without such information, a

bank may close the accounts of money-transmitters, an action begun in 2005 by J. P. Morgan Chase, Wachovia, and Bank of America.

Another financial tool used to transmit and access remittances is cell phone technology. A sender deposits cash (plus a fee) at a remittance center (e.g., telephone company, bank). The money is transmitted electronically through the phone company that sends a text message notifying the recipient that the money is available for collection at a licensed outlet (e.g., department store, bank). Cell phones provide a quick way to move money but obviously require the purchase of a new form of information and communication technology by the customers in addition to skills to use the technology and a monthly cell phone fee, an expensive proposition for people who live on less than \$2 a day.

The idea of “banking the unbanked” has the potential to bring an enormous number of new customers to commercial banks. The World Bank’s Consultative Group to Assist the Poor envisions the three billion poor who live on less than \$2 a day – half the world’s population – benefiting from microfinance (CGAP 2006).

Consumer Credit

Step two in the microfinance model is to turn banking customers into borrowers. Remittances deposited into commercial bank accounts will serve as a gateway to other financial products, specifically loans and credit cards to be used for consumption, home purchase, and/or business development.

Traditionally, bankers have not reached out to poor and working-class people. It is not because capitalism is prejudiced; quite the contrary. Capitalism on its own does not discriminate on the basis of one’s size, shape, or beliefs. From a banker’s point of view, the major impediment to extending credit is the lack of secured collateral that can be repossessed in the event that a customer defaults on the note. Hence, creative methods are being developed to quantify assets of the poor that can be sanctioned as collateral by western financial institutions.

A pioneer in this field is Hernando De Soto (2006) who coined the term “dead capital” to represent “those assets in the extralegal economy that cannot be used for leverage in the formal market” – for example, real estate held without title. Building on his experience in Peru, de Soto is advising the Washington Consensus on how to establish a set of rules to formalize extra-legal activities and to build the requisite institutions to regulate the system. The IDB wants to unlock the estimated \$1.2 trillion in dead capital in Latin America and use these assets to back consumer debt.

As with every other technology humans have adopted, the introduction of microfinancing has no educational or community building component. It raises the concern that many people may not be able to read the fine print on a bank loan or credit

card application. They may not know whether interest is being charged on the full amount of the loan or the declining balance. They may not understand compounded interest calculations and the impact on the bottom line.

Moreover, unlike Argentina – the third largest debtor to the IMF in 2003 – individuals do not have the clout necessary to re-negotiate debt with a bank, credit card company, or mortgage firm if they get in over their heads. In most countries, the laws allow for a company that is in financial trouble to declare bankruptcy and walk away from debt. A nation can default on a loan and re-negotiate the terms by virtue of the size of the debt held. As the adage goes: If you owe the bank \$50,000, you have a problem; if you owe the bank \$50 million, the bank has a problem.

Early evidence of microfinance in India shows that some heavily indebted individuals who cannot meet interest rate payments in excess of 20 percent or do not see a way out of their indebtedness have committed suicide (“Microcredit in India” 2006). Such reports beg the question as to what kind of expectations societies have for citizens who do not fare well economically or become financially vulnerable as a result of new microfinancial products and services.

Insurance Policies

A final example of the newest financial technologies being marketed by the Washington Consensus today is insurance. As the formal economic systems expand in emerging markets, financial institutions will offer insurance policies (e.g., life, health, and home) as another way to bring the poor into the global marketplace. As with any gamble, some people will benefit by purchasing insurance; others will end up losing more than they wager.

A key issue to consider going forward is whether insurance will be voluntary or involuntary for customers who obtain microfinancial products from commercial banks. Peru’s Banco del Trabajo, for example, offers credit cards, consumer loans, remittances, and mortgages to 1.4 million clients. The bank requires that its 78,000 microcredit clients purchase life insurance to cover the notes in the event that the debtor dies. Can people with low-income afford to pay principle, interest, plus mandatory insurance on a loan? If so, what is the advantage of using a microfinance institution instead of traditional lenders?

Micro-Enterprise Development

The United Nations declared 2005 the International Year of Microcredit, marking the entry of large financial institutions into the business of small-scale banking and credit services in emerging markets. The interest builds upon a history of micro-enterprise development, that is, making small amounts of capital available to people with low-incomes. Micro-enterprise began as a charitable effort to help women who live in

poverty earn a little money to feed their children. Pioneers in the field include Nobel Peace Prize recipient Muhammad Yunus of the Grameen Bank in Bangladesh, Sr. Anne Marie Gardiner of Salvadoran Enterprises for Women, and others. Seed money is offered as either a non-collateralized loan (which charges interest below the market rate) or a grant (which creates no future financial obligations).

Poor women have demonstrated that they are attractive customers with loan repayment rates of 95 to 98 percent. As a result, over the past ten years, the number of micro loans increased from approximately 9 million to over 60 million (Women's World Banking 2005). These loans originated from governments (e.g., USAID), multilateral organizations (e.g., IMF, World Bank), for-profits (e.g., Citigroup, HSBC), and nonprofits (e.g., FINCA, ACCION).

Microfinance activities, however, are not necessarily charitable in nature. The Inter-American Development Bank estimates that the return on capital of micro loans exceeds 20 percent, making this a profitable venture. Funds from the March 2006 sale of Morgan Stanley's \$106 million bond will be distributed to sixty-five microfinance institutions that loan to poor people in increments of \$100 to \$500 at 15 to 35 percent interest rates (Sapp 2006). Wall Street is now a microfinance creditor because microfinance is profitable.

Hence, we are witnessing growing competition to dominate microfinance technologies that may result in new partnerships between financial institutions. One of the goals of the IDB's expansion into microfinance is to assist "nonprofit lending organizations in transforming into for-profit, regulated financial institutions" (IDB 2006). This idea is seductive at a time when U.S.-based nonprofit organizations are modeling themselves on for-profit entities, a trend driven in large measure by the fact that over half of nonprofit revenues derive from fees for services (Flynn 2006).

To maintain their unique role, nonprofit banks may want to stay true to their charitable purpose by serving as an intermediary between households in emerging markets and commercial institutions. Nonprofits could offer workshops on banking and finance. They might also assess local trends, financial terms, and performance of microfinance institutions as a form of public education, thus reaffirming their rationale for tax-exemption with the U.S. Internal Revenue Service. Nonprofits could also work with governments who may be called upon to develop codes of conduct to regulate this rapidly growing market and perhaps impose interest-rate caps on loans, an idea rejected by the United Nations (2005).

“Charity Washing”

The Washington Consensus is marketing the new financial technologies associated with microfinance as a form of financial democracy to help disadvantaged people and neglected communities become part of the global economy, to reduce poverty, to increase social inclusion, and to improve living conditions. While the technologies are new, the rhetoric is familiar and suggests that we may be seeing a new form of green washing or “charity washing” in the making. The risk is that new microfinance technologies targeted to people with low incomes will be mistaken as benevolence. Bankers are not in the business of charity. They are wed to the bottom line of generating sufficient profits to stay in business.

If the intention is not charitable than what is it? It appears as if the new microfinance technology being promoted by the Washington Consensus aims to align traditional microcredit for poor women with mainstream market capitalism. Indeed, at the opening gala of the United Nations 2005 International Year of Microcredit, Secretary-General Kofi Annan reminded the group that “microfinance is not charity but a way to extend the same rights and services to low-income households that are available to everyone else.” The reach of global capitalism is ever expanding.

In the years to come, microfinance may prove to be a sound technology for savvy individuals who need secure mechanisms to send remittances home or capital to expand a small business venture. Others who obtain easy money through credit may not do as well due to a lack of education or self-restraint as we saw with many emerging market governments that received winfall loans in the early 1990s. What will happen if large numbers of individuals become overextended on credit cards or default on mortgages? Will we see debtor’s prisons as in the days of yore? What cultural, legal, and social institutions will be needed to ensure that the newest financial technologies benefit society in the short and long term? Perhaps this is the topic of another article.

In the end, lenders will always search for new markets. It is up to the consumer to be savvy when it comes to money. Caveat emptor!

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