Macroeconomic Stabilization and the Microentrepreneur

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ABSTRACT: Macroeconomic instability is largely detrimental to microenterprises. An unstable economic environment generates inflation and thus hits small business and the poor more severely than the more formal, wealthier segments of the population. Stabilization policies, which eliminate these disadvantages of instability, can help microenterprise.

While healthy macroeconomic factors can positively influence the informal economy, the so-called “informal sector” can strengthen the macroeconomy. Given proper underlying conditions, microenterprise may prove as an engine of growth for an entire economy, and not just a small subsector of only marginal macroeconomic importance.

This article discusses the effects of these macro-micro links with a special focus on IMF-style macroeconomic stabilization policy. It argues that macroeconomic instability imposes high costs on microentrepreneurs. Therefore—contrary to popular belief in the development community—macroeconomic stabilization can ultimately be very beneficial to microentrepreneurs, although it can be costly in the short run.

Any development professional who has worked with microentrepreneurs for any length of time has seen instances in which otherwise well-designed projects fail as the positive effects of the project itself are swamped by the negative impact of bad macroeconomic policies or instability. High inflation, economic recession, or currency devaluations—
when unanticipated by either the project designers or the microentrepreneurs themselves—can sink the most well-intentioned of microcredit programs. This phenomenon is not new; indeed, part of the motivation behind the World Bank’s move into structural adjustment lending at a macroeconomic level in the early 1980s was the bank’s repeated experience of seeing numerous projects fail due to problems in the macroeconomic environment.

While the fact that macroeconomics affects microentrepreneurs is well recognized, the nature and causes of such effects are often poorly understood by microcredit professionals. Likewise, macroeconomists at the International Monetary Fund (IMF)\(^1\) and elsewhere generally have little idea of the interaction between the microenterprise sector and their macroeconomic policy recommendations, and they fail to recognize that in many developing countries, the so-called “informal sector” can be of macro-level importance.

This article discusses the effects of these macro-micro links with a special focus on IMF-style macroeconomic stabilization policy. It argues that macroeconomic instability imposes high costs on microentrepreneurs. Therefore—contrary to popular belief in the development community—macroeconomic stabilization can ultimately be very beneficial to microentrepreneurs, although it can be costly in the short run.

**Characteristics of a Crisis Economy**

Not all developing-country economies in crisis look the same. Different problems manifest themselves with varying intensities in distinct circumstances. Nevertheless, there are a number of macroeconomic symp-
Macroeconomic Stabilization and the Microentrepreneur
toms shared by most economies in macroeconomic crisis, which are generally linked to a similar set of underlying causes.

Causes of a Macroeconomic Crisis

The “big three” of underlying macroeconomic problems that generate instability are unsustainable fiscal deficits, unsustainable external current account deficits, and unsustainably lax monetary policy. Simply put, both fiscal and current account deficit problems are induced by over-spending. A fiscal deficit is unsustainable when the government spends more than it can take in through taxes and borrowing. A current account deficit is unsustainable when the country as a whole consumes more goods and services from abroad than it can pay for, through either export earnings or foreign borrowing. It should be stressed that no specific level of government spending is too much per se, nor is any particular pace of imports too high. Some countries are able to finance large fiscal or current account deficits for extended periods of time without crisis because they have ready access to financing. Other countries find such borrowing extremely difficult because they are seen as unreliable, either because of bad current policies (such as overvalued exchange rates or profligate government spending) or because of a high level of accumulated debt from the past. Lax monetary policy is often related to high fiscal deficits as a government, unable to finance its deficits by conventional means, resorts to printing money to cover the gap. Lax monetary policy can also be imposed by a government in an attempt to provide cheap credit to the economy as a means of stimulating economic growth.

Beyond the three macroeconomic causes of instability (fiscal deficits, current account deficits, and loose monetary policy), several underlying problems with the economic structure may lead to a crisis in many developing countries. Most prominent among these, given the economic crises in Mexico in 1995 and East Asia in 1997–98, is financial sector weakness.
In Mexico to a degree, and even more so among the East Asian countries recently suffering from macroeconomic instability, the traditional fiscal and monetary deficiencies that lead to a balance of payments crisis were not major factors. Rather, the unsustainably high current account deficits were related to serious deficiencies in the banking sectors. While the verdict is still out as to the full explanation for the Asian debacle, it appears that poorly monitored and poorly run financial institutions played a crucial role. By overextending themselves with dubious lending, they first fueled an asset price boom and then exacerbated the bust by falling into insolvency when the speculative bubble burst. For the purposes of this discussion, it suffices to note that serious deviations from standard market practices, such as subsidized and directed credit programs and artificially low interest rates, played a crucial role.

Structural problems in the labor market can play a less obvious, but nonetheless important role in macroeconomic instability. In many troubled economies, the labor market is too rigid to permit the kinds of small but steady adjustments that can avert a crisis. The exact problems differ from country to country, but often the formal sector of the economy suffers from tight restrictions on working conditions and labor mobility, overtaxation, unrealistically high minimum wages, and other problems that generate labor market segmentation. The rigid real wages in the formal sector resulting from these problems often contribute to a devaluation-inflation spiral that forces a country with an uncompetitive external position to devalue in order to restore external equilibrium. The devaluation generates inflation, which in turn stimulates increased wages (either from wage indexation or from union pressures), causing inflation to rise even higher. Higher prices and wages once again erode competitiveness, generating a current account crisis—and the cycle begins again.

Other structural rigidities in an economy may also contribute to the macroeconomic crisis, either by exacerbating fiscal or current account
Macroeconomic Stabilization and the Microentrepreneur

deficits, or by making recovery from initial macro imbalances more dif-

cult. Among such rigidities are price controls on key products (such as

food sales or agricultural output), protectionist tariffs, and quotas on

imports.

Symptoms of a Crisis Economy

There are two major macroeconomic results of the unsustainable eco-

nomic policies mentioned above. The first is inflation—the result of

some combination of these fiscal, external, and monetary imbalances. Fisc

al imbalances can induce inflation as governments resort to printing

money to finance the deficit in the absence of other funding sources. Extern

al imbalances can provoke inflation via a devaluation-inflation

spiral whereby the excessive current account deficit triggers successive

currency devaluations in an attempt to regain competitiveness. The

devaluations in turn provoke inflation, which, if not kept in check, cor-

rodes competitiveness again and provokes another current account crisis

and starts the cycle once more. Finally, because inflation is ultimately a

monetary phenomenon, any provocation for increases in the growth rate

of the money supply beyond its sustainable rate will result in inflation.

The second common result of macroeconomic crisis is problems with

GDP growth. Countries suffering from current account or fiscal imbal-

ances often suffer either from prolonged stagnation (like Argentina in

the 1970s and 1980s) or from boom-and-bust cycles, where unsustainable

spurts of growth are followed by sharp contractions (the case of Turkey

in the 1990s or Peru in the 1980s). Stagnation can occur when a country

attempts to forestall the results of unsustainable policies by maintaining

tight controls on the economic structure (which also stunt growth). For

example, a country might implement foreign exchange controls and high

tariffs in an attempt to stave off external imbalances, or impose interest

rate and price controls in an effort to counteract the inflationary effects
of printing money to finance a large fiscal deficit. These types of restrictions can often postpone a crisis, but the restrictions on imposed economic activity take a toll on the dynamism of the economy. In contrast, boom-and-bust cycles result from a government’s attempt to stoke the furnace of growth via unsustainable monetary or fiscal policy. The resulting imbalances produce a crisis that in turn forces an economic contraction. Once the crisis has hit bottom, the government sees a need to restore growth and again begins its expansionary efforts, producing yet another crisis, and so on.

Effects of Macroeconomic Crisis on the Microentrepreneur

Having briefly reviewed the causes and results of macroeconomic crisis, I now turn to discussing its impact on the microentrepreneur. While it is true that fiscal imbalance or balance of payments deficit per se may not be bad for the microentrepreneur, when these disequilibria generate economic crisis, they can have serious negative effects.

Inflation—The Microentrepreneur’s Worst Enemy

Inflation hits microentrepreneurs hard. In fact, it probably affects them disproportionately compared to other, more prosperous segments of the economy. This is true on several levels. First, inflation is, in essence, a tax on holders of cash money. Those who hold more money therefore pay more of this tax. While this may give the impression that rich people would pay more inflation tax than the poor, that is not generally true. The inflation tax falls disproportionately on those who rely most on cash. The wealthy, especially in high inflation economies, have alternative instruments to use in place of cash-interest-bearing bank deposits, bank accounts abroad, credit cards, real estate investments—which do not pay inflation tax. Microentrepreneurs, in contrast, generally rely heavily on
Macroeconomic Stabilization and the Microentrepreneur

cash in their business and personal economic activities. They often have very limited access to financial instruments to avoid inflation.

Accelerating or highly volatile inflation rates can have particularly pernicious effects on microentrepreneurs. Sophisticated large enterprises in economies with variable inflation often employ teams of experts to manage their assets against inflation’s corrosive effects. Small entrepreneurs, on the other hand, often use rudimentary accounting systems and rely on markup pricing techniques that can fail utterly in an accelerating inflation environment, causing microenterprises to become decapitalized.4

These negative inflation effects are particularly acute in the area of microcredit. Not only can individual microentrepreneurs become decapitalized by inflation, but entire microcredit programs can collapse. When credit programs involve rotating or guarantee funds, the value of these facilities can be wiped out when inflation kicks in, or when it accelerates beyond the level foreseen when the funds were originally lent. Unlike the private banking system, which will raise interest rates and shorten loan maturities quickly (and ruthlessly) to maintain their profit margins, microcredit programs can be destroyed by inflation because they tend to lend at longer maturities, at lower interest rates, and often lack sophisticated credit management policies. Even when interest rates are adjusted to account for high inflation, volatility in the rate can also cripple microcredit programs.

Consider a country expecting an inflation rate of 8% (plus or minus 2%). A lender can set interest rates at 15% and be confident of a real return of 5% on the loan. If, as in the case of Turkey today, inflation is expected to be 80% (plus or minus 20%), a lender must set interest rates at 110% to guarantee the same 5% real rate of return. The volatility in proportional terms is the same for both cases, but the impact on a borrowing microentrepreneur would be very different. In the low inflation
case, a nominal interest rate of 15% would result in a real interest rate between 5% and 9%, depending on the level of inflation. This variance could be accommodated easily in the investment plans of most borrowers. In the case of high and volatile inflation, on the other hand, the real interest rate could be anywhere between 5% and 31%, a range that could make investment much more difficult for a borrower.

“Boom and Bust” is Bad for Microentrepreneurs

The cycles of boom and bust often produced by a macroeconomically unstable economy can also be bad for microentrepreneurs for at least three reasons. First, boom-and-bust cycles in a fundamentally unstable economy will result in lower growth over the business cycle than stable, albeit less spectacular, growth. To the extent that microentrepreneurs benefit from higher economic growth in general, they would prefer this stable growth to boom and bust. For example, in the ten years since stabilization in the mid-1980s, Bolivia’s growth has averaged a modest 3.5% per year without ever exceeding 6%. But that performance is far superior to what Bolivia experienced in the 15 years before when, despite the seven-year boom in the early 1970s when GDP grew by some 6% per year, the average growth over the boom-and-bust cycle was a meager 1.8% per year. A similar phenomenon occurred in Peru in the late 1980s, when the government of Alán García pushed the economy into an unsustainable boom in 1985–87, followed by a bust in the late 1980s. During the two boom years, GDP grew by more than 9%; but in the succeeding three years, the bust was also nearly 9% per year, leaving the economy with negative growth plus severe hyperinflation during the García years.

Boom and bust can be harmful to microenterprises because it is produced by distortionary economic policies that can discriminate against them. This is the case with the Import Substitution Industrialization (ISI) policies followed in much of the developing world in the 1960s and
1970s. ISI policies generally involved subsidizing credit and foreign exchange to favored, large-scale industrial development projects, while the remainder of the economy (including microentrepreneurs) paid with higher interest rates, more costly foreign exchange, and expensive imports due to high tariff barriers.

**Underlying Structural Problems Can Also Be Harmful to Microenterprise**

Distortions in the economic structure underlying macroeconomic instability in developing countries can, in and of themselves, pose serious impediments to the growth of microenterprise. Financial sector distortions are one such impediment. As advocates of microcredit programs are well aware, the microenterprise sector is often either ignored or marginalized by formal sector financial institutions, and distortionary policies in this sector to “improve” credit allocation rarely favor the microentrepreneur. Directed credit programs are rarely directed toward microenterprise. In an economy in which some of the available credit pool is directed toward favored firms, the interest rates for the remaining borrowers (microentrepreneurs among them) are higher than they would otherwise have been. Interest rate controls do not work well, but to the extent that they do, they induce credit rationing. Rationing regimes usually favor large, low-risk borrowers, or the politically well connected. The microentrepreneur is not one of the so privileged. More generally, a closed and secretive financial system breeds cronyism, but microentrepreneurs are not the cronies who benefit. Finally, restrictions on the financial system contribute to inadequate development of financial markets and to poorly capitalized banks (particularly when publicly owned). A shallow and poorly capitalized financial system is a recipe for triggering the kind of macroeconomic crisis suffered in Asia in 1997 and Mexico in 1995.
Rigidities in labor markets can also have negative effects on the microentrepreneur. While it may seem paradoxical, regulations in the organized, formal labor market designed to improve wages and working conditions can actually depress incomes and conditions in the microenterprise sector. This occurs because these regulations often contribute to segmentation of the labor market, and segmentation hurts those in the unfavored segments. For example, when regulations push up minimum formal sector wages, those employed in formal firms improve their lot; but firms respond by cutting back formal employment, driving more people into the informal labor market to compete with the microentrepreneurs and laborers already there, driving down their wages.

Similar arguments could be made regarding other structural distortions of the economy, although it is true that not every distortion of free-market forces disfavors the microentrepreneur. Price controls are a case in point; they depend on the products subject to controls. In many African countries, for example, price controls have been imposed on agricultural products. This hurts small farmers, while favoring the small merchants and industrial producers of urban microenterprise. On the other hand, foreign exchange controls often disfavor the microenterprise sector because they are rarely granted access to foreign currency and the more favorable rates.

**Characteristics of Typical “Orthodox” Stabilization Policies**

Having explored both the characteristics of an unstable economy and the reasons why instability is bad for microentrepreneurs, I now turn to the characteristics of the typical IMF-style stabilization policy and its effects on the economy. While in my opinion the oft-heard criticism that the IMF dishes out cookie-cutter stabilization programs throughout the world without regard for national conditions is unfounded, it is true that a
number of characteristics are common to most orthodox stabilization programs (including those not involving outside organizations like the IMF). These policies can be grouped according to the four policy problems they address: fiscal deficits, balance of payments problems, inflation, and structural problems.

Fiscal Deficit Reduction

Orthodox stabilization policies generally include provisions to reduce the fiscal deficit for several reasons: The deficit may be unsustainable in the sense that the government can no longer finance it; it may be generating inflation or balance-of-payments problems by boosting domestic demand excessively; or it may “crowd out” private investment, thus depressing growth. Whatever the motivation, some combination of spending cuts and tax increases is commonly recommended to shrink the deficit. On the spending side, cuts ideally are concentrated on less productive government activities (such as military spending or the size of the bureaucracy), with remaining resources redirected toward more crucial government functions. In practice, the degree to which spending cuts approximate this ideal varies greatly from country to country depending on the domestic political environment.

Fifteen or twenty years ago, little provision was made in most stabilization programs for preserving programs that affect the poor, let alone providing additional resources to cushion the costs of macroeconomic adjustment. That is no longer the case. Today it is unusual to see an adjustment program without a special “social safety net” component to catch individuals whose income topples as a result of the program. On the revenue side, stabilization programs commonly include measures aimed at simplifying the tax system by reducing the number of different taxes, unifying tax rates, and cutting tax shelters and loopholes. In the process, however, the overall tax burden generally rises. The exact break-
down between expenditure cuts and tax increases usually depends on the overall size of government spending in the economy (larger governments receive higher cuts), but it might also vary according to other factors (such as limits on a government’s revenue-raising ability).

**Tackling Balance-of-Payments Problems**

In dealing with an external imbalance, orthodox stabilization programs rely on three sets of policies: measures to cut domestic demand, devaluations, and steps to improve financing of the current account deficit. Cutting domestic demand reduces the demand for imports and improves the balance of payments on that side of the equation. Tighter fiscal policy reduces public sector demand and may also reduce private demand, as the government transfers less money to the private sector via transfer payments or as the government extracts spending money from private hands in increased taxes. Tighter monetary policy also depresses demand by raising interest rates, which in turn lower investment and consumer spending financed by credit. Devaluation is another tool often used in stabilization policies to improve the current account. A devaluation raises the price of imports (in domestic currency terms) while making a country’s exports more attractive abroad by lowering their cost to foreign buyers. Obviously, since imports become more expensive, devaluations have a demand-reduction component as well. The final component of a balance-of-payments policy is action to improve financing of the current account deficit. It is generally not optimal for a developing country to run a current account surplus (which means the country exports investment capital abroad). A deficit is desirable to provide needed imports with foreign capital financing investment projects. A balance-of-payments crisis arises only when the gap between exports and imports is larger than what can be financed abroad. In addition to reducing the overall size of the deficit, orthodox stabilization programs provide
money to cover part of the remaining deficit (that is the explicit purpose of IMF loans). The higher domestic interest rates induced by tight monetary policy can also partially finance a current account deficit by attracting foreign capital to the country.

**Reducing Inflation**

As already mentioned, tight monetary policy is a common component of stabilization policies, because it can assist in a balance-of-payments crisis by both reducing domestic demand and encouraging inflows of foreign capital. In addition, tight monetary policy is an important element in the fight against inflation, both by reducing inflationary pressures from high domestic demand and by restricting the quantity of money available. Fiscal policy also plays a role in the fight against inflation, since it is often a fiscal imbalance that provokes the emission of inflationary quantities of money.

**Addressing the Underlying Structural Problems of the Economy**

Increasingly, economic crises around the world are provoked by the macroeconomic effects of underlying structural problems. As a result, IMF stabilization programs more and more often include important structural reform components. These structural reforms generally address weaknesses that cause crises and improve overall economic efficiency.

Privatization of public enterprises is often high on the agenda of stabilization programs. In many crisis economies, fiscal imbalances have been exacerbated by losses registered by inefficient government-owned monopolies. Sale of these enterprises to private investors can thus help improve the fiscal balance. In addition, these firms commonly occupy crucial positions in the economy (basic utilities, energy, transport, bank-
ing, etc.), and their inefficiency has negative repercussions for the productivity of the entire economy. In the external sector, structural reform generally requires the reduction and homogenization of tariff rates and the elimination of quantitative restrictions on imports. These measures reduce protection for inefficient domestic industries and the distortion of investment priorities, which arises from differential protection. They can have the negative side effect of aggravating current account problems by making imports less expensive. It is for this reason that trade liberalization is often undertaken in stages or is linked explicitly to devaluation.

As recent experience in Asia has convincingly demonstrated, weakness in the banking system can provoke a macroeconomic crisis, or at the very least aggravate an already existing crisis. Thus, financial sector reforms are taking center stage in the structural reform agenda. Measures enforced in this area include the closure, sale, or consolidation of insolvent banks and deregulation of interest rates, and increased regulatory supervision regarding the quality of banking system assets. The elimination of subsidized or direct lending programs and the privatization of state-owned banks also play an important role in many reform programs.

Finally, labor market reforms can play an important role in economic restructuring, although they often take much longer than the initial drive for stabilization. Barriers to the flexible use of labor are reduced, collective bargaining decentralized, and non-wage costs (social security contributions, taxes, dismissal costs) reduced. Often, public sector wages are cut, inducing a corresponding reduction in some private sector wages. Countries with unrealistically high minimum wages often freeze the wage or introduce new flexible contracts not subject to the same stringent requirements as those of previous workers.
Macroeconomic Stabilization and the Microentrepreneur

Effects of Stabilization Policies on Microenterprise

To summarize the article thus far, its argument is that macroeconomic instability harms microentrepreneurs in various ways. Instability itself hurts microenterprise by depressing overall economic growth and by stoking the fires of inflation. In addition, the financial, labor, and other structural rigidities that often provoke macroeconomic crisis also have generally negative effects on microenterprise. If this is the case, one might reason that the policies to cure macroeconomic instability should, by implication, be good for microenterprise. This is where my argument becomes controversial, since it is widely held in the NGO community working with microenterprise that stabilization policies are bad for the poor and for small enterprise. Is this a case of the cure being worse than the disease? To answer this question, we now look at how the stabilization policies described in the previous section affect the microentrepreneur. We must be careful, however, about what we compare the effects of stabilization policy with. Comparing the situation of microentrepreneurs before and after stabilization gives an incomplete picture, because the status quo ante was not a sustainable one. That is the definition of a crisis after all—an unsustainable economic imbalance. Rather, the comparison should be between how microentrepreneurs fare under orthodox stabilization and how they might fare if the crisis had continued unchecked or if some other approach to stabilization been applied.5

Any evaluation of the costs and benefits of orthodox stabilization for microentrepreneurs must begin by acknowledging that there are both costs and benefits. Adjustment is not a painless process for anyone in society. Furthermore, some sectors pay more of the consequences of stabilization than others. Moreover, the balance between costs and benefits varies over time. Initially, adjustment can be very costly, with the benefits appearing more and more prominent only over time. With these
caveats in mind, let us examine the impacts on microenterprise in each of the main areas of adjustment policy.

**Stabilization Generally Induces Economic Recessions that Hurt Microenterprise**

As even a casual observer of developing countries realizes, the combination of tight fiscal and tight monetary policies contained in many stabilization policies often provokes an economic recession. The severity of the drop in economic growth depends on the degree of adjustment needed to restore stability, the severity of the prestabilization crisis, and the speed and comprehensiveness with which reforms are undertaken. In some of the most severe economic crises in recent years (Bolivia in the mid-1980s, Peru and Argentina in the early 1990s), stabilization was achieved with relatively little additional reduction in output above what had already occurred in the downward spiral toward instability. These severe cases often showed a rapid return to strongly positive economic growth, perhaps reflecting the depth to which the countries had already sunk, or the speed and comprehensiveness with which reforms were implemented. Nevertheless, it remains the case that, generally, stabilizing countries pay a short-term price in terms of economic growth, and that price is shared by the microenterprise sector. What is not at all clear is whether microentrepreneurs suffer disproportionately from stabilization-induced recessions, as is commonly asserted. Since in many countries recessions do expand the ranks of microenterprise and depress incomes there (as people losing jobs in the formal economy set themselves up in independent economic activities to generate income and compete with existing microentrepreneurs), it is likely that drops in economic activity do affect the small business sector more than proportionately. However, in a stabilization
package where drops in output are accompanied by important anti-inflation and structural adjustment components, the total package may have very different costs and benefits.

**Fiscal Contraction Has an Ambiguous Effect**

Depending on how fiscal adjustment is undertaken in a stabilization, microenterprise could be less or more affected. If social spending programs for the poor are cut sharply in the austerity drive and microentrepreneurs benefit from such programs, then obviously they will be hit hard. If, on the other hand, austerity involves cuts in public sector wages, subsidies to public enterprises, or reductions in large-scale investment programs, microenterprise should fare relatively well. On the tax side, any increases are likely to hit microentrepreneurs less severely than other sectors of the economy because they tend to have relatively low incomes and to be difficult to tax due to their small size.

**Devaluations Often Favor Microenterprise**

Devaluations make imported goods more expensive. Thus the cost of a devaluation falls more heavily on those who import more. On a business level, microenterprises tend to have a much lower import coefficient than large, formal enterprises, so they will suffer less. On a household level, families in the microenterprise sector also tend to consume fewer imported products than those in higher income strata, so here, too, the effects are less severe for microentrepreneurs and their families. Moreover, when imports become more expensive, consumers tend to shift spending toward domestic substitutes for foreign goods. Because microenterprises often produce such substitutes, the demand for their goods can actually rise, improving their incomes.
Tight Monetary Policy to Reduce Inflation Favors Microentrepreneurs

Tight monetary policy is one of the factors causing stabilization-related recessions, so in this sense, tight money can hurt the microentrepreneur. But there are at least two reasons to think that microentrepreneurs are less seriously affected. Tight money contracts output through the effect of higher interest rates on consumption and investment, but since microentrepreneurs are less involved in credit markets, they pay less of the business cost of higher rates. If tighter monetary policy combines with financial sector reforms to make access to credit fairer and more open, microentrepreneurs might actually see an improvement in their access to loans. Even more important, tight monetary policy is the number-one policy tool in the fight against inflation. If temporarily higher interest rates result in a permanent reduction in the inflation rate (entrepreneurs number-one enemy), the net effect might well be favorable for microenterprise.

Structural Reforms Are Almost Always Good for Microentrepreneurs

As discussed in detail above, the structural reforms included in orthodox stabilization programs are generally oriented toward eliminating distortions in the economy that favor some groups over others. Because microentrepreneurs are rarely among the favored few, they stand to lose little—and quite possibly gain much—from such reforms. A few examples from different structural areas illustrate this point:

• Privatization and the restructuring of public enterprises can have a salutary effect on microenterprise by improving the basic public services on which they rely for their business operations (electric-
ity, water, telephones, transport). In some cases, privatization can even directly involve microenterprises.  
• Financial sector reforms generally result in easier access to credit for firms that are not politically well connected, microenterprises among them. They can also reduce the costs of credit as banks improve their efficiency in the wake of deregulation and privatization. In countries where directed or subsidized credit programs target microentrepreneurs, there may be some cost, but in most economies microentrepreneurs would be helped by the elimination of directed credit.

Conclusion

This article has argued that macroeconomic instability is largely detrimental to microenterprises. It lowers overall economic performance, which hurts microenterprise along with its economic sectors. It generates inflation and thus hits small business and the poor more severely than the more formal, wealthier segments of the population. And economic instability is generally associated with numerous microeconomic distortions in the labor markets, financial systems, and external trade that almost inevitably hurt smaller, less politically influential economic agents like microentrepreneurs. It follows from this that stabilization policies which eliminate these disadvantages of instability can help microenterprise. While acknowledging that orthodox stabilization policies involve short-run costs for microentrepreneurs, I argue that in the long run, microenterprise stands to gain much more from a stable, growing, and unfettered economy. Furthermore, it does not seem that the microenterprise sector shoulders a disproportionate share of this stabilization burden. Indeed, in terms of the benefits from inflation reduction and structural reform, they may well fare better than most. Given proper underlying conditions, microenterprise may prove an engine of growth.
for an entire economy, and not just a small subsector of only marginal macroeconomic importance. There is some evidence that this has already occurred in some economies at some points of their development. During the late 1980s, microenterprises participating in the BRI-KUPEDES credit project in Indonesia directly generated roughly one-eighth of the country’s economic growth. In Bolivia in the early 1990s, successive household income surveys found that the single most dynamic segment of the national economy was small enterprise, contributing significantly to overall economic growth. In Bangladesh, where the Grameen Bank has now had a long history of microcredit lending to large numbers of people, the success achieved has almost certainly been of macroeconomic importance. Other examples could certainly be cited. The argument 20 years ago among some analysts that the informal sector should be ignored or repressed because it lacked any growth potential has been definitively rebutted by events. It remains for governments, NGOs, aid agencies, and the microentrepreneurs themselves to set in place the policies necessary to realize the potential now known to exist for growth and development through microenterprise.

Notes

1. The views expressed in this article are those of the author and do not necessarily represent those of the IMF.
2. A sustainable noninflationary rate of monetary growth would be the rate of increase consistent with real economic growth and financial market deepening.
3. Inflation is a tax in the following sense: The government accrues revenue from printing money (known as seignorage), but printing additional money for a given level of economic activity raises prices, eroding the purchasing power of money holdings. In this way, the revenue accruing to the government by printing money comes from an appropriation of part of the value of holders of money.
4. An example of this occurred in Peru while I was in the process of microenterprise research in 1988, at the start of an inflationary spiral that culminated in hyperinflation. One of the most common complaints of microentrepreneurs surveyed in Lima was decapitalization. When I delved into the causes of this phe-
Macroeconomic Stabilization and the Microentrepreneur

nomenon, it became clear that most microentrepreneurs worked on a simple markup pricing system: They bought their inputs and sold the final product at a price approximately 50% higher than they had paid (a lower margin for commerce). With inflation running at more than 600% per year, a turnaround on production every two months would mean that the ostensible 50% markup was really only 12%, leaving the microentrepreneur without sufficient income to sustain consumption and maintain working capital. Even when entrepreneurs began to factor in a given amount of inflation, they were constantly caught short by the fact that inflation was accelerating.

5. There have been other types of stabilizations. Peru, Argentina, and Brazil all tried so-called “heterodox” stabilization policies in the mid-1980s, which may be compared to the orthodox policies implemented there later. In the recent Asian crisis, Malaysia decided to forego an IMF lending program and implement an indigenous adjustment strategy. In future years this will provide another instructive contrast.

6. Even this conclusion must be tempered. Empirical studies have often found a larger informal economy with lower incomes after stabilization than before. However, that finding alone does not mean that stabilization hurts them disproportionately. Three other considerations should be made—but rarely are—in the literature. First, there is a composition effect: New entrants to the sector may have lower incomes than the existing entrepreneurs, lowering the average income in the sector without lowering incomes of preexisting microenterprises. Second, as mentioned in the main text, the prestabilization versus poststabilization comparison neglects the real possibility that incomes in the sector might well have declined more in the absence of stabilization. Third, although studies showing falling incomes in the sector are fairly common, there is little evidence that falls are larger in microenterprises than elsewhere.

7. Examples of this are an increase in the auto repair business (often microenterprise) when the price of imported new cars rises or an increase in demand for domestically sewn clothes when imported clothes become more expensive due to devaluation.

8. For example, in La Paz, Bolivia, trash collection was privatized in the early 1990s, with microenterprises capturing a significant share of the service contracts issued.
Macroeconomic Stabilization and the Microentrepreneur