

Managing Risk to Save the Poor

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The G-8 finance ministers have agreed to cancel \$40 billion of debt owed by eighteen of the world's poorest countries. This is a triumph for common sense. But, at only \$238 per person in the eighteen countries, debt relief alone is hardly enough to help the poor.

Fortunately, other efforts will complement the developed countries' increased generosity. The most notable is a significant movement towards providing finely focused risk-management services to the poor, which could ultimately prove to be worth far more than \$40 billion.

We tend to think that new risk-management products, such as novel types of insurance or financial derivatives, will primarily interest the rich, or at least relatively wealthy people. In fact, new risk-management products are being developed for some of the poorest people in Africa, Asia, and Latin America.

It is important to recognize that the world's poorest people are not the same people from year to year. Good fortune and bad fortune alternate randomly, and the poorest people are particularly vulnerable when misfortune – like a hurricane in a fishing village – strikes. So risk management, by smoothing out bumps in income, can be extremely important in alleviating the effects of poverty.

Moreover, if unmanaged, risk destroys the prospect of economic growth. Without risk management, poor people will not experiment with new crops or more productive methods, because any mistake could be disastrous.

For example, in subsistence rural areas, a bad harvest may lead to starvation before the next year's crop is in. More typically, it leads "merely" to a sudden collapse in the economic base, leading to years of hardship in the future. If a poor family in subsistence farming receives no help during the year after a bad harvest, its members may eat their beasts of burden, cut down the trees that provide nutrients to the soil, sell whatever farming equipment they have, and even eat the seeds that were set aside for planting the following season. Providing money when it is needed is essential.

Unfortunately, according to Joanna Syroka of the World Bank's Commodity Risk Management Group, official foreign aid and private charity tends to arrive too late, often after starvation has actually begun, and long after the families have taken extreme measures, consuming their capital to survive. While the aid may keep them alive, they are left economically paralyzed for years to come. Syroka and her colleagues are striving to promote the use of modern financial technology to make sure that aid arrives in time – and in sufficient volume – to avert such outcomes.

The old tool for managing farmers' risks is crop insurance, which responds directly to the failure of a crop. But crop insurance suffers from what economists call a "moral hazard," because it

reduces farmers' incentives to ensure the crop's success. The farmer may neglect the crop or refuse to invest in saving a failing crop if he knows that a payout is forthcoming. The farmer may even plant a crop that he knows will fail. This is why private crop insurers are in short supply, and why crop insurance often requires expensive government subsidies.

But insurance technology is improving, aided by improved information technology. The moral hazard implicit in crop insurance can be addressed by making payouts depend not on the actual crop failure but on the bad weather that caused it. Since the farmer cannot influence the weather, there is no moral hazard.

In the past, weather insurance could not manage a farmer's risk effectively because we could not measure well enough the effects of weather on crops. For insurance to be effective as a risk-management device, weather must be measured at a finely-detailed local level, and the correct measurements must be taken at the correct time. Crops are especially vulnerable at certain times, for example, when seeds begin germinating or when bad weather the previous year puts perennials at risk.

Today, weather insurance uses an expanded number of sophisticated weather stations and deep knowledge of the science of agriculture to measure weather's effects on local agriculture. Different crops are affected differently, and weather insurance must take account of a farm's various crops and when they were planted – complexities that modern information technology can solve.

Many companies are already involved in offering improved weather insurance to poor farmers, with notable successes from ICICI Lombard and BASIX in India, and from the International Finance Corporation and the insurance company Credo Classic in Ukraine. Similar work is underway in Africa, led by the World Bank and in Central America various countries' governments are collaborating with the Inter-American Development Bank and the Central American Bank for Economic Integration. The number of agencies and governments involved in the movement towards sophisticated risks management for the poor is inspiring.

At the same time, the application of risk-management technology, insurance, and finance requires little of stretched foreign-aid budgets: a relatively small number of office workers, cell phones, and computers. With the ongoing revolution in information and communications technology, the phones and computers will cost less and less, even as the costs of many commodities needed for development grow.

Jeffrey Sachs's new book *The End of Poverty* argues that with proper help from advanced countries the world could see the end of poverty as we know it in coming decades, prompting some to describe him as a starry-eyed idealist. But if we take account of both the increased generosity of rich nations and the application of improved financial and insurance technology, he just might be right.