Finance and Poverty Alleviation: Evidence and policies

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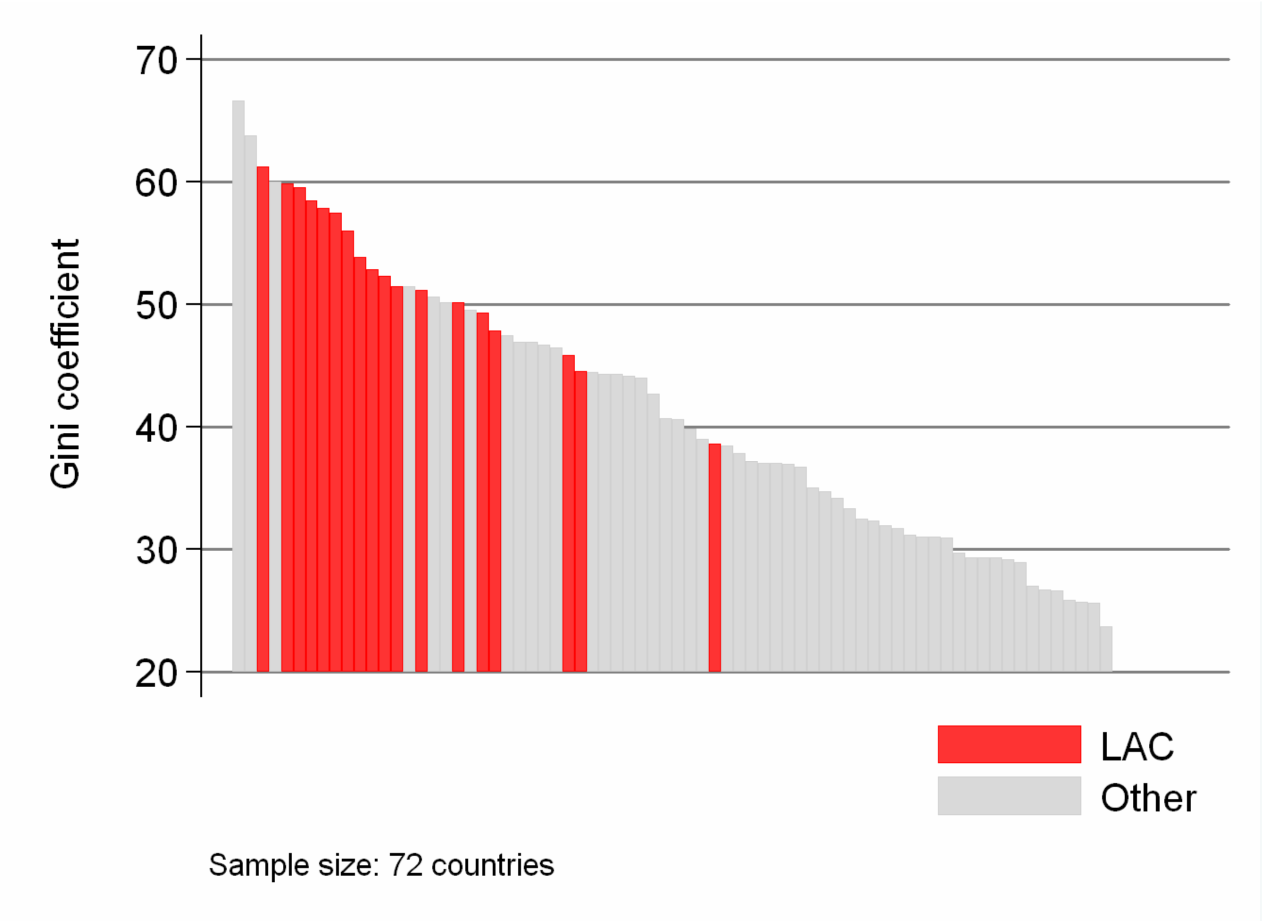
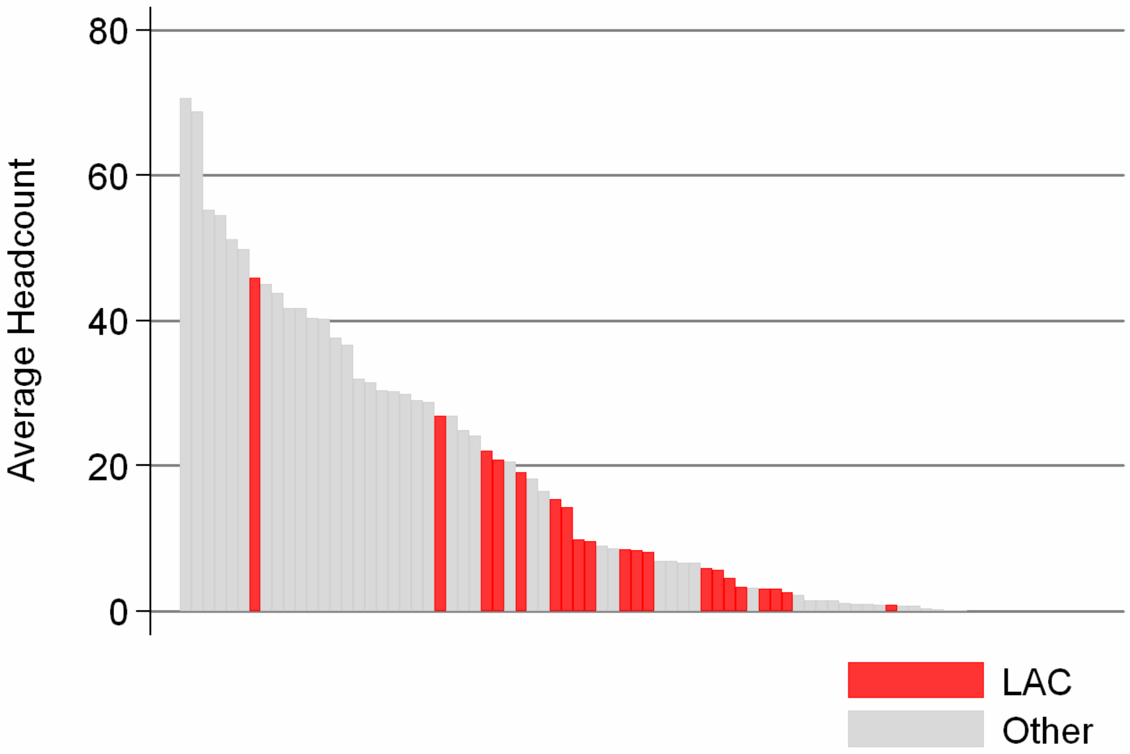
Motivation

- Large variation in in income inequality and poverty levels across countries
- What are policies to reduce inequality and poverty?
- Finance is pro-growth, but who benefits? Is it also pro-poor? Is there a growth-distribution trade-off?
- What should financial sector policy focus on?
    - Depth/efficiency vs. breadth/inclusion
    - Credit vs. savings/payment services
- Policies to deepen and broaden financial systems

Income inequality across countries

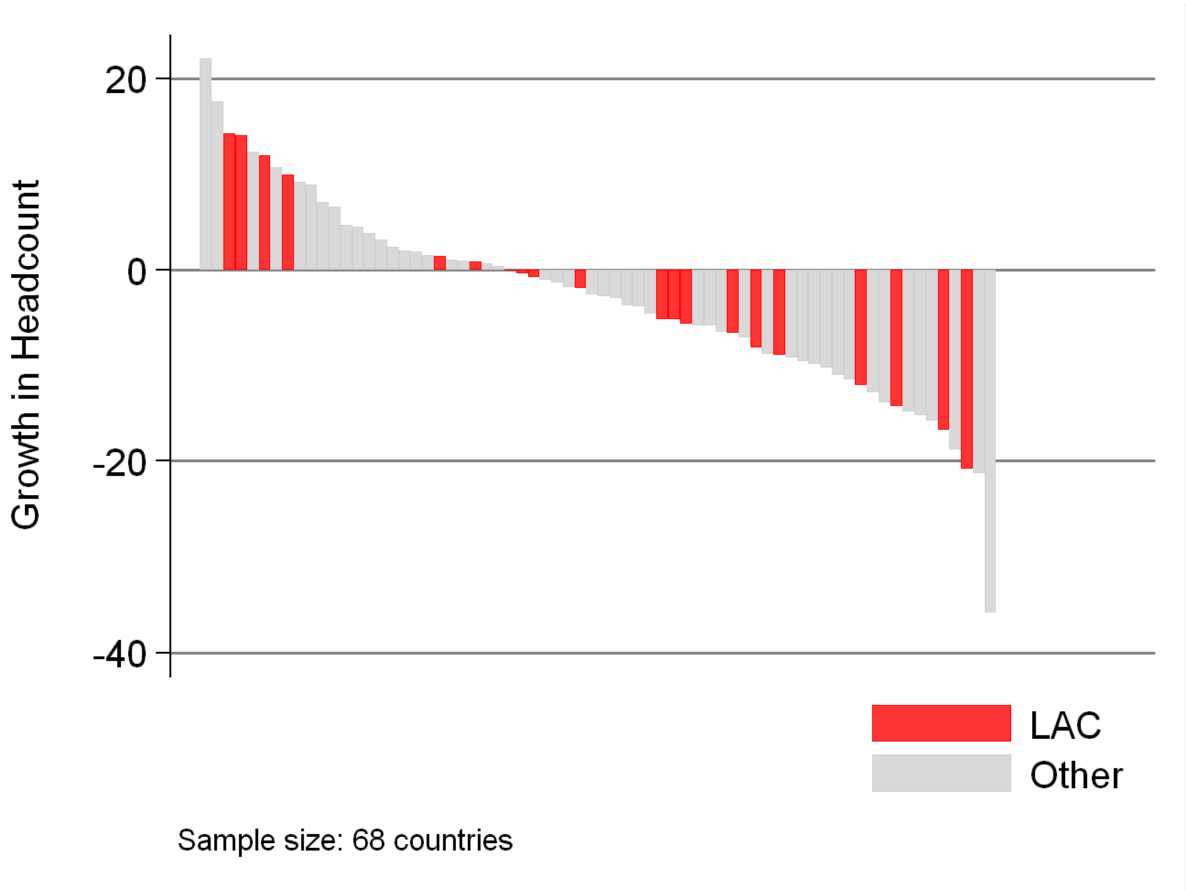


Poverty levels across countries



Sample size: 68 countries

Changes in poverty levels across countries



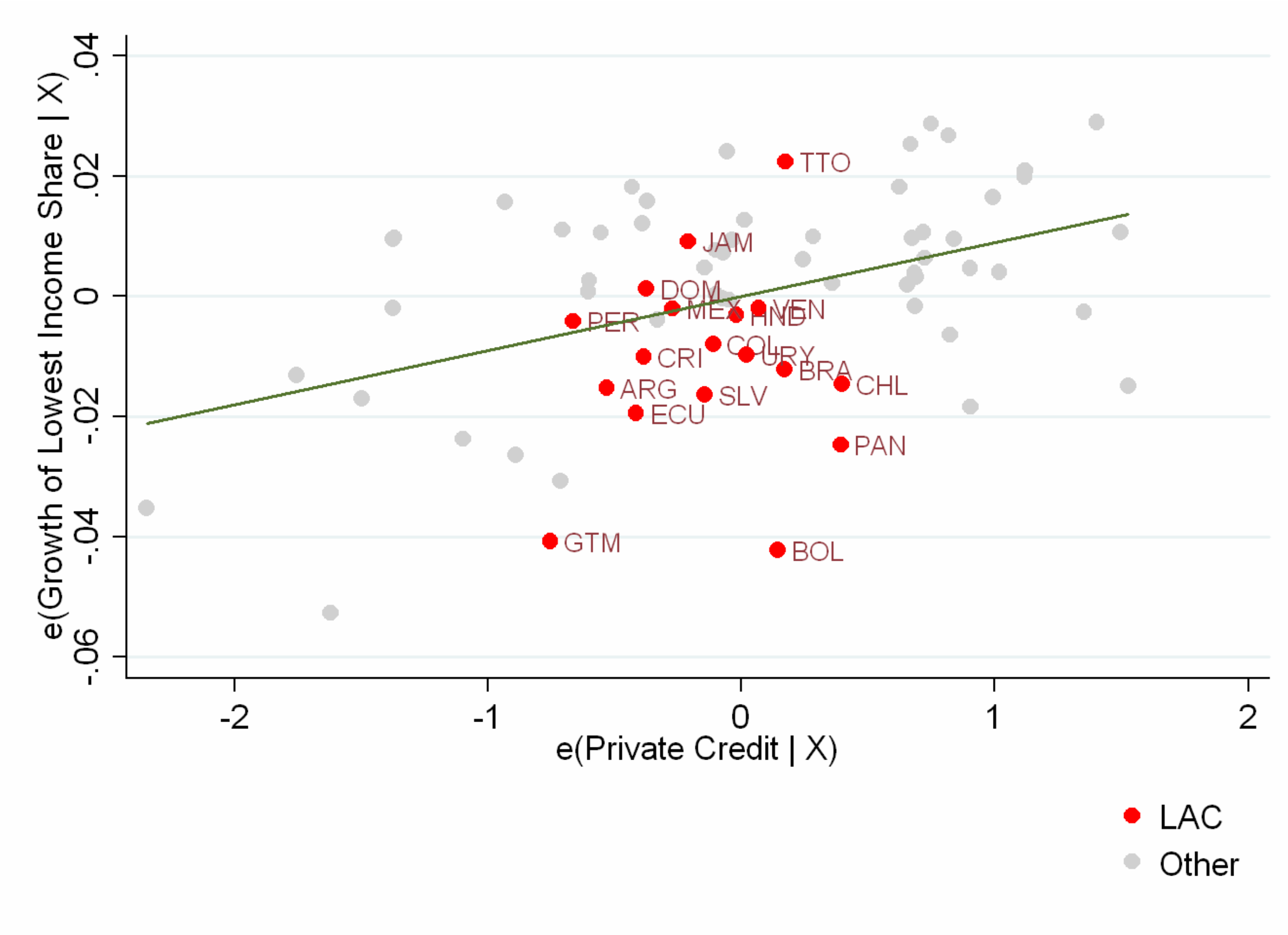
Finance and income inequality - Theory

- Pro-poor
  - Credit constraints are particularly binding for the poor (Banerjee and Newman,1993; Galor and Zeira, 1993; Aghion and Bolton, 1997)
  - Finance helps overcome barriers of indivisible investment (McKinnon, 1973)
  - Finance foster economy-wide openness and competition by facilitating entry (Rajan and Zingales, 2003)
- Pro-rich:
  - Non-linear relationship (Greenwood and Jovanovic, 1993)
  - Credit is channeled to incumbent and connected and not to entrepreneurs with best opportunities (Lamoreaux, 1986; Haber, 1991)

Finance, Inequality and Poverty Alleviation – Cross-country evidence

- Assess relationship between financial development and changes in income share of poorest quintile, Gini coefficient and Headcount
- 72 countries
- Data averaged over 60-05 and 80-05
- Control for other country characteristics
- Outlier tests, instrumental variable techniques

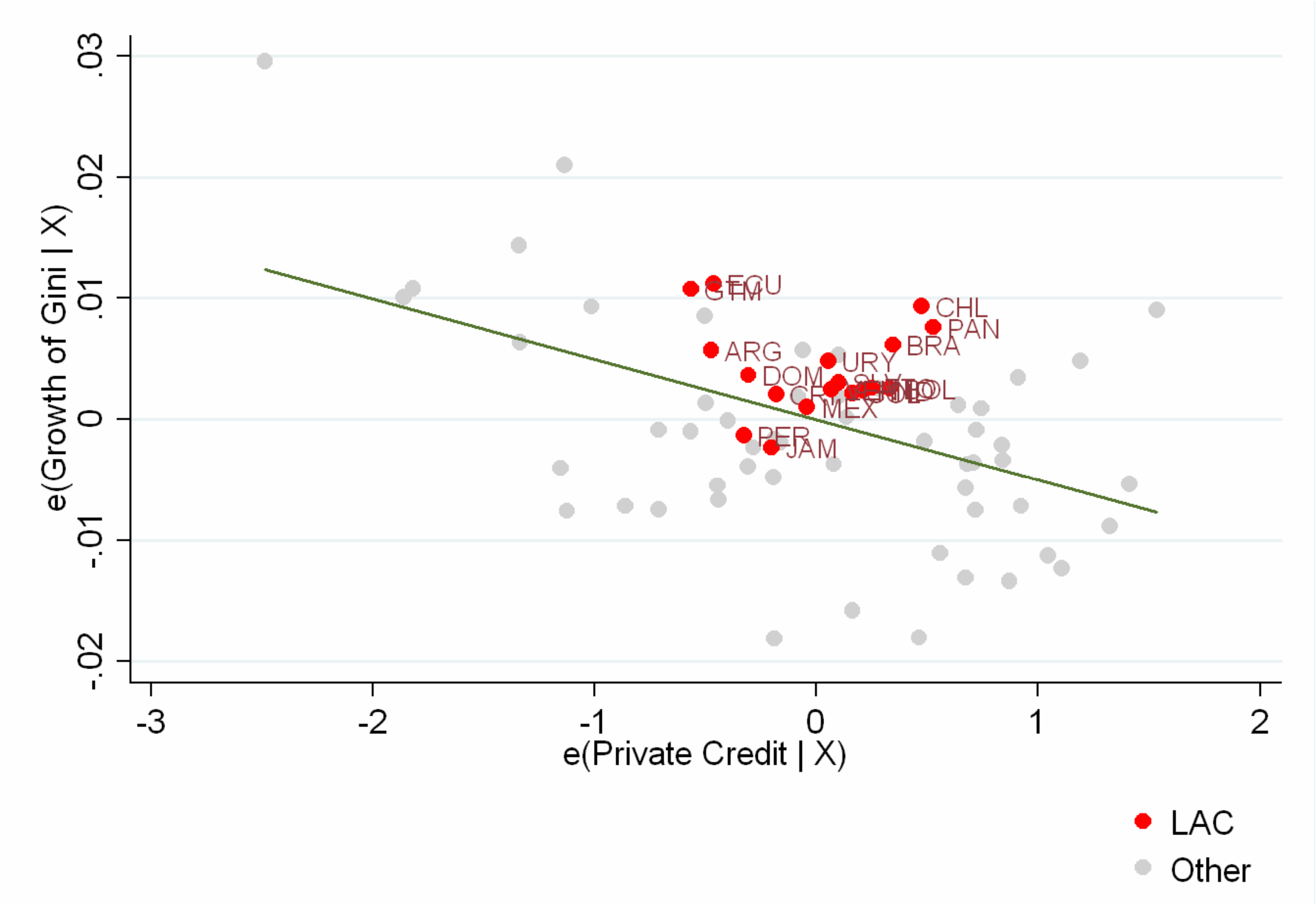
Finance and growth of lowest income share



Finance and Income Inequality – the economic effect

- Compare Private Credit to GDP
  - Brazil 33%
  - Canada 63%
- Had Brazil had Private Credit to GDP level of Canada, its growth of lowest income share would have been -0.1% instead of actual -0.7% and the lowest income share in 2000 would have been 3% instead of the actual 2.4%.

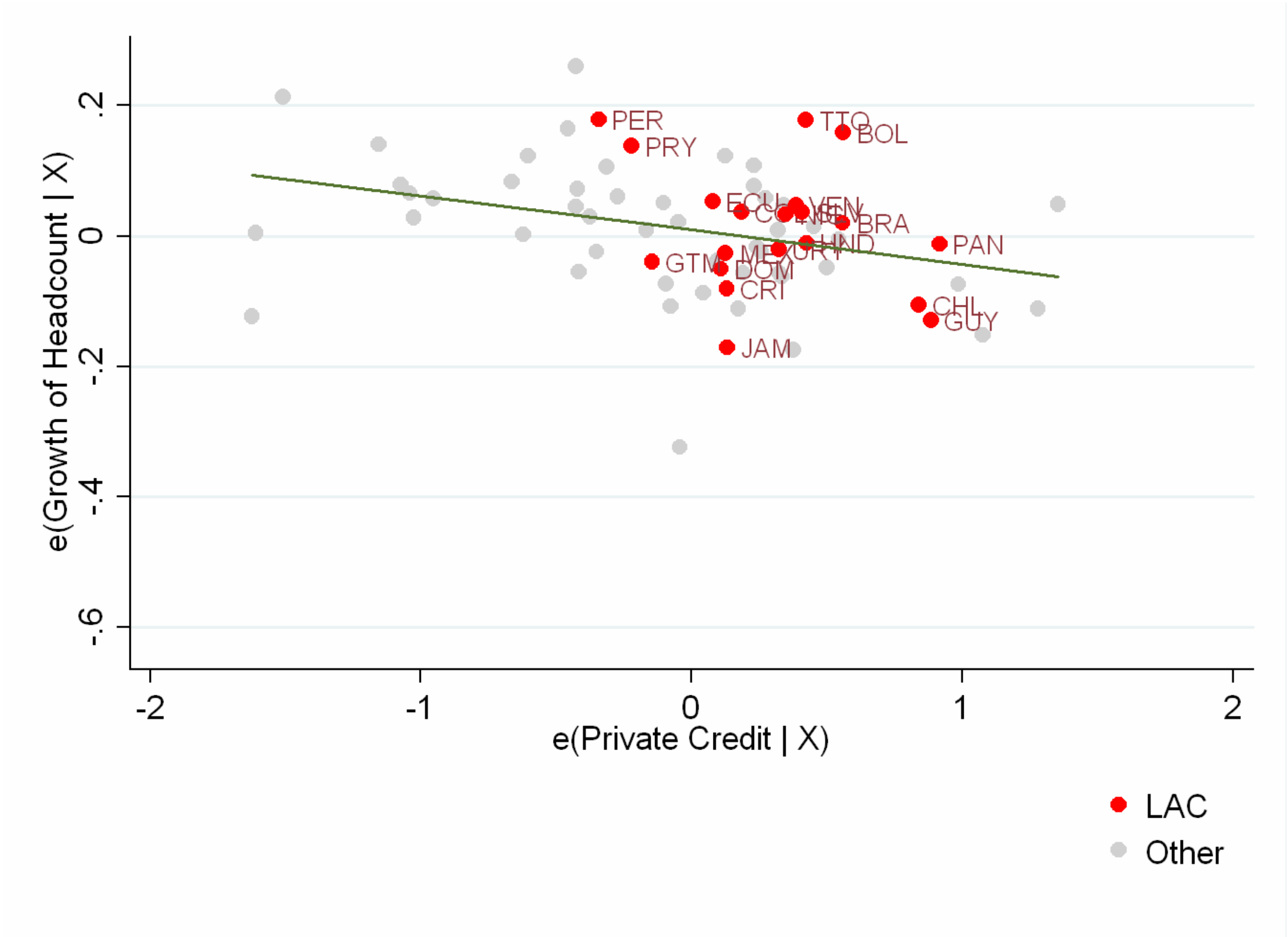
Finance and growth of Gini



Finance and Income Inequality – the economic effect

- Compare Private Credit to GDP
  - Guatemala 14%
  - El Salvador 26%
- Had Guatemala had Private Credit to GDP level of El Salvador, its growth of Gini would have been 0.6% instead of actual 0.9% and the Gini in 2000 would have been 56 instead of the actual 60

Finance and poverty alleviation



Finance and Poverty Alleviation – the economic effect

- Compare Private Credit to GDP
  - Peru 17%
  - Chile 47%
- Had Peru had Private Credit to GDP level of Chile, its headcount would have been 5% in 2002 instead of the actual 12%.
- Notes of caution:
  - in-sample large change;
  - Result does not tell us how to increase financial development!

Finance and Poverty Alleviation - growth effect vs. income inequality effect

- Both growth and distribution channels matter for effect of finance on poverty alleviation
- Stronger growth effect in poor and more equal societies
- Stronger distribution effect in rich and less equal societies

Finance and the poor

- Finance is pro-growth and pro-poor!
- Important caveats of cross-country work:
  - Measurement
  - Identification
  - Channels
- Turn to specific policy intervention to assess impact of financial liberalization on income distribution

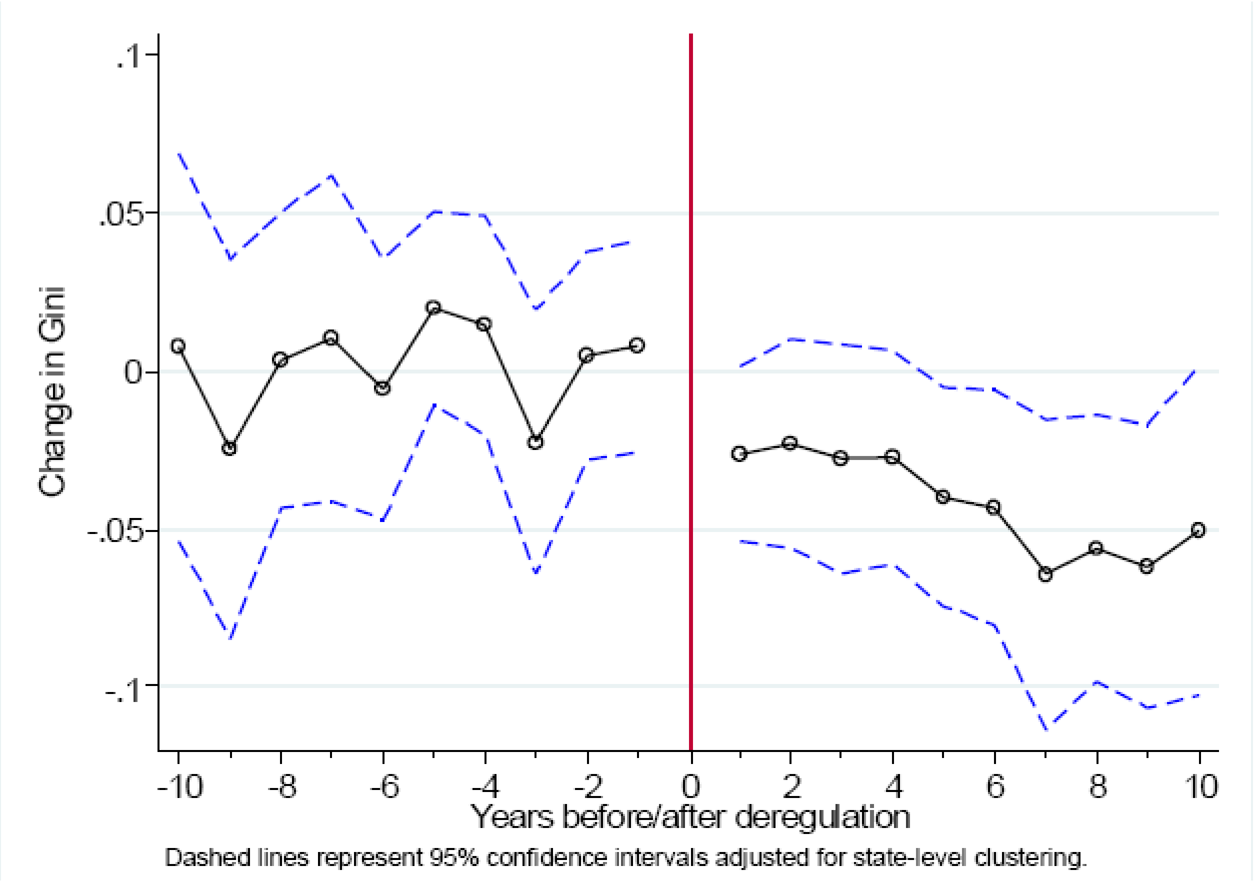
Branching restrictions in the U.S.

- Until mid-1970s most states restricted the ability of banks to freely branch within states and across states, reducing competition
- Technological progress undermined these restrictions
- From mid-1970s until 1994 (Riegle-Neal Act), most states did away within intra- and inter-state branch restrictions
  - Growth accelerated
  - Bank efficiency improved
  - Rate of new incorporations increased
  - Volatility decreased
- What about income distribution?

Cross-state, cross-time estimation

- Deregulation at different times allows to exploit state-time-panel
- Difference-in-difference estimation of relationship between branch deregulation and log(Gini)
- Control for state and year dummies and time-variant state characteristics
- 1977 to 2003
- Little concerns of endogeneity
- Single policy change - reduce identification and comparability problems often associated with cross-country comparisons

The effect of branch deregulation on income inequality



Branch Deregulation and Income Distribution – Economic effect

- Coefficient: 0.013
- Within-state, within-time standard deviation of log of Gini 0.034

- Branching deregulation explains 40% of variation of log Gini relative to state and year averages.

Branch deregulation and income distribution – the channels

- Reduction in credit constraints on the poor
  - Increase in human capital accumulation; but: no change in educational attainment; effect of branch deregulation is on levels not on slope of Gini
  - Increase in entrepreneurship; but: largest drop in wage income distribution

Decomposition of Variance

Branch deregulation and the labor market

	Wage rate	Hours	FTFY
All	-.021	15.064***	.016***
Unskilled	-.019	20.111***	.018***
Skilled	-.015	1.523	.009*

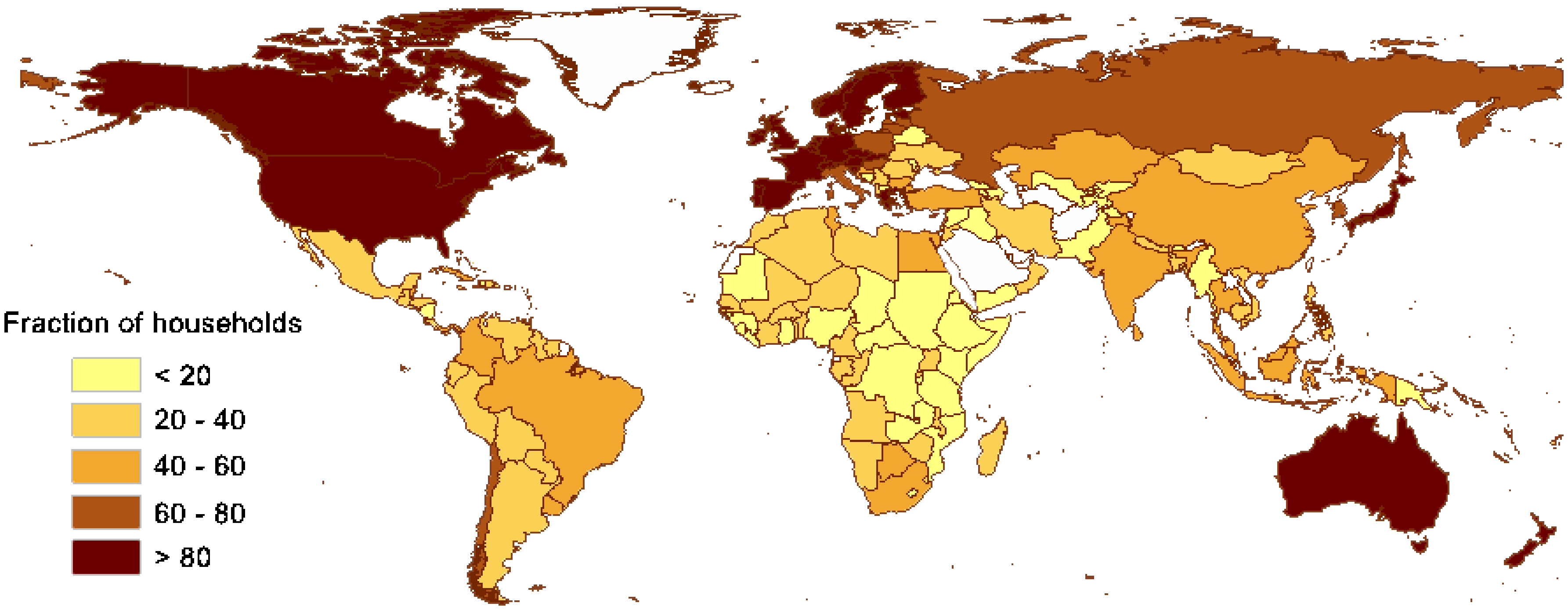
Branch deregulation and income distribution – labor market channel

- Labor market effect: Deregulation boosts labor demand primarily for the unskilled.
- This increases the employment of less skilled workers, explaining reduction in wage income gap
- Effect of branch deregulation goes through improved capital allocation, not through expanding access to credit services

Finance and poverty – the bigger picture

- Aggregate studies – that take into account spill-over effects - suggest stronger impact
- Rigorous microcredit studies find mixed results on the impact of access to credit by the poor
  - Large share of microcredit used for consumption purposes
  - Aggregate effect limited due to limited resources in MF segment
- General equilibrium models for Thailand also suggest indirect effects of financial development may be quite significant for the poor – i.e. transiting into formal sector and higher wages
- **⇒ To promote pro-poor growth it is important to improve access for all excluded (not only the poor)**
- **⇒ Effect of financial development on poverty alleviation comes through improved capital allocation, not necessarily through extending access to credit to all.**

Fraction of households with an account



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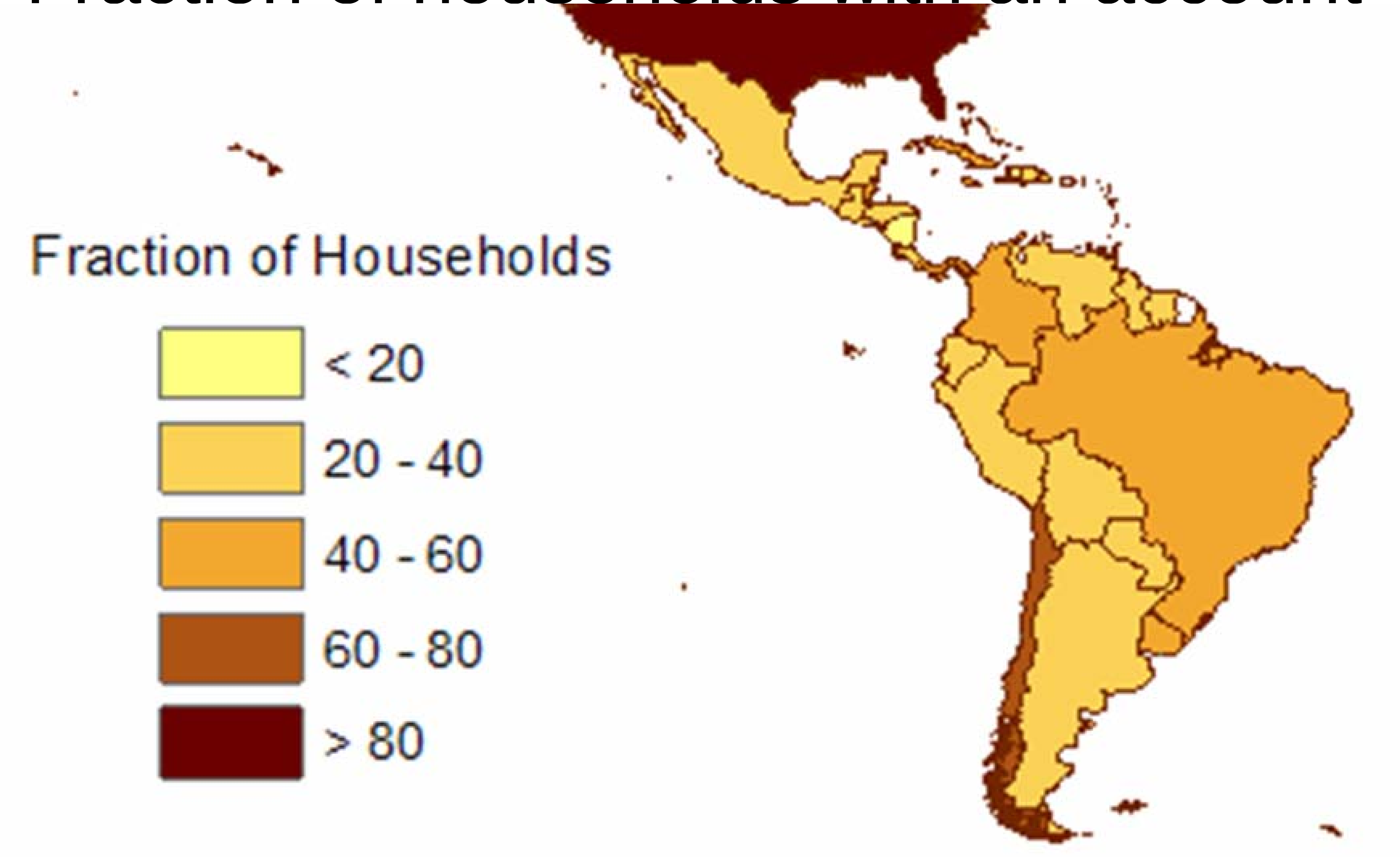

Finance and poverty – looking beyond credit

- For poor households credit is not the only – or principal – service they need
- The use of credit for consumption purposes points to lack of adequate savings services
  - Geographic distance as barrier to savings (Aportela, 1999)
  - Importance of local savings banks, post offices etc.
  - Use of commitment devices might help (Ashraf et al.)
- Payment services might be very important, especially for receiving remittances
  - Remittances second largest source of external finance for developing countries
  - Channeling remittances through banking sector can increase depth and outreach of banking system
  - High costs of sending remittances that can be brought down with competition and financial education campaigns

Access to finance - role for government?

- Yes: markets will not provide for all

  ….but
- Need realistic goals – not everybody should use credit
- Not all government policies are equally effective in broadening access
  - Market-replacing policies have mostly failed
  - Focusing on institutional framework might not be enough
- The very poor are likely to need subsidies to access financial services. However, given the negative incentive effects of subsidizing credit, and the fact that for poor households savings and payment services may be more important, subsidies may be better spent on these.

Access to finance – policy choices

- Market-developing policies: focus on institution building
  - Macroeconomic stability; improvements in contractual/informational framework;
  - Long-term institution building process; how to prioritize?
  - Information infrastructures (credit registries.) over enforcement of creditor rights; ease of recovery on individual debt contracts (collateral) over resolution of conflicts between different claimants (bankruptcy laws)
- Market-enabling policies: help maximize access within current institutional framework
  - Promote cost-effective technologies - legislation for leasing, factoring etc. reduce costs of registering and repossessing collateral; financial education
  - Competition - including foreign entry - is likely to improve access over time
  - Regulatory policies – no bias against SME lending
  - Pro-market activism (infrastructure, demonstration effect, coordination problems etc.)
- Market-harnessing policies: prevent financial system from moving to imprudent outcome beyond frontier
  - Incentive compatible financial safety net that minimizes moral hazard risk
  - Disclosure requirement, predatory lending regulation and education to prevent individual overborrowing

Technology vs. subsidies

- Access Possibilities Frontier moves with technology
  - Internet, m-finance, access to global markets
- Allowing/encouraging private sector to exploit new opportunities might have greater returns than subsidizing old methodologies /technologies
  - Encourage innovation
  - Legal clarity for new products
  - Low entry barriers for new institutions and new products; look beyond banks

Conclusions

- Finance is not only pro-growth, but also pro-poor.
- There are large spill-over and indirect effects of finance: Pro-poor policy should improve access for all excluded.
- There is a role for government
  - Identify bottleneck – focus policies accordingly
  - Focus on market-enabling rather than market-replacing policies
  - Focus on technology rather than subsidizing old products

Want to know more?

www.worldbank.org/financeforall

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Thank you