

Chapter 4

The Financial Sector's Contribution to Pro-poor Growth

Why is the topic important for pro-poor growth?

First and foremost, a well-developed financial sector – understood as the central bank, commercial banks, non-banking financial institutions (which include microfinance institutions and alternative finance institutions such as co-operatives, credit unions and savings banks), as well as the financial markets – is important for promoting private sector development and subsequently the contribution of the private sector to alleviating poverty.

The financial sector contributes to reducing poverty and improving opportunities for the poor directly, indirectly and by making economic growth more pro-poor.

The financial sector can have a more direct impact on poverty reduction in two ways:

- i) A well-developed financial system allows the poor to have access to financial services, which they are often denied. They need to have access to a large array of financial services, such as saving facilities, payment instruments, credit, and insurance. When the poor accumulate savings as a precaution against unforeseen events or with a view to financing investments in housing or child education, it is important for them to have their savings in liquid assets and in a safe place. They also need credit on various occasions: to finance equipment or inputs needed for revenue generating activities, to pay for education or to help them recover from difficult situations resulting from economic crises, natural disasters or health accidents. Credit is of particular importance in rural areas where farmers have to face a time lag before they receive the proceeds from selling their crops. They also sometimes suffer from drought, flood or shocks. There is increasing evidence of the ways in which financial services touch the lives of poor directly.¹ However, in the absence of well-functioning formal markets, individuals and firms seek other less efficient means of risk management. Informal systems are common in the early stages of development. As they emanate from local cultures and customs, the procedures are simple and easily understood by the population, but such systems are usually characterised by high risks and usurious rates of interest.
- ii) The financial sector can facilitate the financing of investments for the provision of basic services to the poor. Improving access for the poor to basic services such as water distribution, power, health services and education is necessary to reach the Millennium Development Goals. However, current volumes of official development assistance (ODA), foreign direct investment (FDI) and domestic savings fall short of what is needed to finance the corresponding investments. Additional private resources will be required to augment those coming from the public sector. A sound financial sector will not only reassure private investors but also facilitate financial flows and create new opportunities.

The financial sector can also contribute to poverty reduction indirectly, as a diversified and competitive financial sector plays an important role in economic development generally. Indeed, a well-functioning financial sector contributes to the maintenance of economic stability; it provides a means of payment and makes possible secure financial and commercial transactions; it helps to mobilise domestic and external savings; and it is crucial for the efficient allocation of capital to productive investments. As growth

contributes to poverty reduction, at least in absolute terms, the financial sector therefore facilitates and contributes indirectly to poverty alleviation.

In addition, the financial sector is essential for making economic growth pro-poor. Indeed, growth is not always pro-poor and in order for poor men and women to benefit from economic growth, the poor need to have access to markets and thereby be able to take advantage of opportunities. As highlighted in “Accelerating Pro-Poor Growth through Support for Private Sector Development”, market outcomes are influenced by policies and institutions in five main areas: providing incentives for entrepreneurship and investment, increasing productivity, harnessing international linkages, improving market access and functioning and reducing risk and vulnerability. In each of these areas, the financial sector plays an important role:

- i) **Providing incentives for entrepreneurship and investment:** access to financial services ensures that entrepreneurs have the facilities with which to do business and provides credit to allow them to make productive investments (in new technology, for example); monetary and fiscal discipline is also important for providing stability and reducing risks for vulnerable people and small businesses.
- ii) **Increasing productivity through competition and innovation.** Investments in equipment, technology or education need to be financed and are key to increasing the productivity of individuals as well as of enterprises.
- iii) **Harnessing international linkages** to take advantage of trade liberalisation and private capital flows. Dynamic trade flows require a proper payment system as well as trade financing mechanisms. The financial sector should provide safe, cost-effective and transparent formal channels for money transfers, including remittances. Moreover, a stable financial system is important for securing FDI as well as portfolio flows.
- iv) **Improving market access and functioning.** Financial markets are one of the markets for which access is vital for the poor. By enabling the poor to draw down accumulated savings and/or to borrow to invest in income-enhancing assets (including human assets e.g. through health and education) and to start micro-enterprises, wider access to financial services generates employment, increases incomes and reduces poverty. Deepening the financial sector also gives more opportunities to the poor to have access to capital markets.
- v) **Reducing risk and vulnerability.** Financial sector policy is crucial for macroeconomic stability, in order to avoid collective bank failure, inflation or currency crises. The development of insurance services, including those serving the poor, can also mitigate risks. By enabling the poor to save in a secure place, the provision of bank accounts (or other savings facilities) and insurance allows them to establish a buffer against shocks, thus reducing vulnerability and minimising the need for other coping strategies such as asset sales that may damage long-term income prospects.

What do we know so far?

The links between financial sector development, growth and poverty reduction

Despite measurement and definitional problems, most research has found evidence of a correlation between financial sector development, growth and poverty reduction.² It is legitimate to infer that, while there is a circular causation mechanism between financial sector development and growth, in developing countries the impact of financial sector development on growth is more important than the reverse. There is evidence that the less developed an economy the stronger the impact of the financial sector on economic growth. In particular, it has been highlighted that a country with a high level of education cannot reap the full benefits

of this unless the financial sector is reasonably well developed. It is also clear that the underdevelopment of the financial sector has a negative impact on growth. Some research goes as far as identifying a poverty trap, meaning that a weak financial sector limits the number of market players and creates a vicious circle, as low market development leads to low growth and to an even weaker financial sector.

Development of the financial sector has also been shown to have positive effects on poverty reduction, although it is difficult to split out the direct effect of access to financial services on poverty from the indirect effect via overall economic growth, partly because of a lack of data.

Microfinance institutions

At the micro level, there is also evidence of the positive effect of providing the poor with access to the financial sector through microfinance institutions (MFI), when they are properly managed.³ The positive role of MFIs in poverty reduction is well established and documented, even though this sector encompasses a wide variety of institutions, with differences in the quality of management and efficiency.

Deficiencies in financial sectors in developing countries

Despite improvements in the last decade, the financial systems of developing countries still suffer from shortcomings and market inefficiencies that have an impact at various levels of the business environment.

Financial systems are fragile

Whatever the immediate macroeconomic and financial policy errors (exchange rate policy, for example), the 1997-98 financial crisis in Asia highlighted some fundamental flaws in developing country financial sectors. These flaws are linked to: i) problems caused by governments interfering in the allocation of resources through credit controls and regulated interest rates; ii) the lack of regulatory, accounting and operating procedures that comply with international standards, coupled with poor quality and opaque supervision and a lack of transparency; and iii) the almost systematic reliance on short-term foreign funding because local debt and equity markets are insufficiently developed.

Since the financial crisis of the last decade, the international community and governments have become aware of the necessity of achieving financial stability and transparency to avoid systemic risks and have been working continuously in this direction.

Financial systems are incomplete

First and foremost, formal financial systems in developing countries are incomplete and deficient. The majority of people do not have access to basic formal financial services. It is estimated that the proportion of people without a bank account reaches 90% in some African countries.

The weakness of the formal financial sector is a severe handicap for developing countries. Capital and money markets are still under-developed. Very few developing countries enjoy the macroeconomic stability needed to create even medium-term, let alone long-term, debt markets. They do not have government securities that can provide the reference values needed to establish an interest rate curve and few investors are willing to invest beyond a one or two-year time horizon, most of them fearing that the large-scale

macroeconomic fluctuations to which these markets are exposed will compromise returns on investments.

There is little competition in the financial sector, which is often dominated by a handful of foreign banks, a few residual state-owned banks and under-capitalised local banks that operate in a segmented market. It is easier to create a vigorous financial market when there is genuine competition.

Lending to the private sector is insufficient. There is a lack of medium and long-term lending and a lack of instruments and institutions adapted to business needs, while the cost of credit is often too high for want of competition.

This situation is partly the result of deficient legal and regulatory frameworks that do not ensure a favourable business environment. Arbitration procedures and court decisions are too slow and open to influence and do not provide enough certainty, especially as regards debt collection (difficulty in realising mortgage guarantees, weak property rights). Banking regulations are ill suited to medium and long-term credit, which is often treated in the same way as short-term lending. Rules on contingency provisions are too strict for small-scale transactions (acknowledgement of mortgages only, which are expensive to register) and microfinance institutions do not always have a specific regulatory status.

What is controversial – supporting the enabling environment or direct interventions: Exclusive or complementary practices?

The case against direct intervention

Direct intervention, i.e. direct financial support to enterprises, banks or MFIs, in the past has often produced disappointing outcomes and some donors tend to advise against it, giving higher priority to actions related to improving enabling environments and institutions.

Direct intervention may result in market distortion and crowding out of the private sector through unfair competition. Such distortions could lead to misallocation of resources, thus reducing growth. There is a risk, for instance, that donor funds provided to an individual bank would give it an unfair advantage and prevent market forces from selecting the best competitor.

Donor funds may be better used to help build an enabling environment for the development and the deepening of the financial sector as a whole; in other words, direct support could be a sub-optimal use of donors' funds.

There is a risk that direct intervention might not bring about sustainable financial sector development, meaning that the services or the financing provided may disappear when donor support is no longer available.

Even if they are efficient, the impact of direct interventions depends on other factors such as the existence of an enabling environment. A study⁴ shows that credit guarantee schemes can be effective in promoting sustainable changes in lender behaviour, leading to financial sector deepening, but only in situations where specific factors for success exist. These factors include the existence of an open, competitive banking environment, a dynamic and/or expanding business sector and a policy environment in which initiatives are co-ordinated and other government or donor initiatives do not crowd out market-driven initiatives, in particular through the provision of subsidised credit or other financial products and services. In such scenarios, guarantee schemes have the potential to play a role of accelerator rather than driver in deepening the financial sector.⁵

The case for direct intervention

While recognising the importance of the enabling environment and institutions, some donors consider that direct intervention is still beneficial, provided precautions are taken to avoid market distortion. There are a number of contexts in which direct intervention remains justified:

- i) The recourse to public-private partnerships (PPPs) can lead to donors and development financial institutions (DFIs) directly participating in financing an activity or in a guarantee structure for it. PPPs are especially needed to finance infrastructure, including water or power distribution projects that are essential for increasing services for the poor. In these cases, donors' and DFIs' roles, as catalysts to attract private financing, are key. It is a good way to maximise the leverage of ODA.
- ii) Appropriate interventions of donors on the market may open new channels, help develop new activities or create new instruments. For instance, providing guarantees to a special purpose vehicle issuing bonds on a local market may be a useful way of directing under-used savings towards investments and of avoiding foreign exchange risk thanks to the provision of loans in local currencies. Concessional credit lines to banks where the use of the grant is strictly limited to a specific development objective can have a strong demonstration effect.
- iii) Changes in institutions or in regulation take time and while they are a necessary condition for developing the market they are not sufficient. For instance, in fragile states or in post-crisis situations, donors' direct interventions can have a powerful leverage effect on financial flows and provide an appropriate response to the emergency and the high level of risk in such situations. In less urgent cases, even if interest rates are liberalised and banks can legally extend medium or long-term loans, they are not ready to do it, due to lack of expertise, insufficient information or aversion to risk. Financial engineering introduced and supported by donors can address this, by promoting instruments such as guarantees, credit enhancements and specific financial vehicles. Microfinance is a good case in point: even in developed countries with a sophisticated financial sector, the poor have difficulty accessing financial services. All the more so in developing countries; a good competitive banking system does not guarantee that the needs of the poor will be addressed. In such countries, direct donor intervention has allowed microfinance institutions to grow, which in certain cases has attracted banks into this activity.

Best practices

When designing priorities for support, donors should consider the type of financial sector in which they intervene. In countries with less developed financial sectors, a pro-active approach should be applied. Priority should be given to assistance geared towards creating an "enabling environment": support for the regulation, supervision and promotion of financial systems. In more sophisticated economies, donors should be pro-active and support policies and projects that extend the provision of financial services to the poor. These types of approaches are complementary and not exclusive but some attention should be paid to the sequencing of donor support.

When contributing to the creation, development or strengthening of the legal and regulatory environment, which is essential, donors should closely co-ordinate their actions at a macro-level, making sure there is no overlap or contradiction between approaches.

However, when donors extend support to financial intermediaries, different views and practices can foster innovation, provided that some basic principles are respected, especially the avoidance of market distortion.

When conditions are met for donors to play a catalytic role in building public-private partnerships by using public funding, they could consider blending concessional and non-concessional resources, setting strict rules concerning the use of concessional funding. The decision on whether to offer concessional funding should be independent of the nature (public/private) of the intermediary, but when the intermediary is a private entity great care should be taken so as to avoid market distortion. It means in particular that the concessional resources should be allocated in a transparent way to deserving beneficiaries or uses such as: i) investments aimed at strengthening the sector's environment; ii) providing services for poor people who do not have easy access to private services; iii) supporting public borrowers who implicitly play a balancing role between social action and profitable business; or iv) investments with a strong environmental and/or social impact. Finally, donors should only use concessional funding during pilot stages and seek to build sustainable solutions that will exist after their withdrawal.

Donors should aim for sustainable, long-term impacts from their interventions when providing financial support for small and medium-sized enterprises (SMEs). Therefore, if they provide credit lines or guarantees to financial intermediaries, it is particularly important that they cover only a portion of the risk and make sure that a significant part is borne by the lender. If such precautions are taken, this type of assistance can have a demonstration effect and help financial intermediaries to learn how to manage the risk of lending to SMEs. It can also help to build expertise and reduce information asymmetries by giving the lending institutions the opportunity to gather information on SMEs' credit worthiness.

When refinancing microfinance institutions, donors should avoid subsidies, except in some instances such as capacity development, and use subordinated debt instruments in local currencies. Subsidies, which may have been necessary at the beginning of microfinance, are not the right tool when it comes to mature institutions that are already sustainable and only need help to grow. Indeed, the donor's role has evolved with the development of microfinance, and donors should now aim to consolidate existing microfinance institutions and strengthen their financial and institutional viability.

Policy implications and suggestions for donors

Information on financial sectors in developing countries

Designing strategies for financial sector development, and connecting the poor to this sector, requires a better understanding of initial conditions and constraints. Therefore, in order to increase the focus on the issue of access, there is a need for more information on levels of access to financial services, barriers to widening access, scale and the nature of unmet demand. Donors and DFIs should encourage the collection of such data by financial institutions or through household surveys on access to financial services.

Business environment

The development, strengthening and consolidation of the institutional and legal environment is of particular importance in broadening and deepening the financial sector. The main aim of donors' interventions should be to make sure that the authorities have the willingness and all the necessary tools to develop the financial sector. They should also be

encouraged to remain focused on the objective of enhancing access to financial services, including in financial sector assessments such as the Financial Sector Assessment Program (FSAP) run jointly by the World Bank and the International Monetary Fund (IMF). In this respect it is mainly the responsibility of multilateral organisations to act, for instance the IMF when it comes to monetary, financial or fiscal policies, but bilateral donors also have a role to play. They could in particular encourage the professionalisation of supervisory authorities and market regulators. They could also support the development of financial infrastructure, for instance helping to set up credit bureaux and asset registries.

It is also necessary, in order to improve the quality and the transparency of the financial sector, to help developing countries to implement international financial standards and codes; this concerns in particular corporate governance, international accounting and auditing systems.

Financial intermediaries

Strong financial intermediaries will lead to better resources allocation. As part of a long-term strategy to make financial markets respond better to the needs and constraints of the poor, there may be a need for donors to provide support to financial intermediaries such as banks, insurance companies, institutions specialised in refinancing local authorities, and microfinance institutions. Modernisation of payment systems is also an important issue: in particular the spread of electronic money and the transfer of remittances. Donors could also consider interventions that help intermediaries that operate in sectors where returns are low or deferred, for example, education, healthcare, housing, small business, farming and refinancing.

Financial engineering

Financial instruments are needed to devise innovative and well-adapted solutions, while increasing the leverage of donors' funds. This is of particular interest for the financing of investment in pro-poor infrastructure, such as water or power distribution. But it can also be of value in other instances. For example, a bank may have a portfolio with a lower risk rating than that of the bank itself; in such a case donors could help the bank to raise money through a securitisation transaction. New resources could then be tapped on more favourable terms and via the local market. It is worth promoting instruments such as guarantees, credit enhancement, specific financial vehicles and public-private partnerships as ways of increasing the leverage of public sector resources on private sector ones. In this regard, donors who can draw on the requisite specialist expertise could play the role of a catalyst: they can help structure specific financing schemes to attract other investors (foreign or local) and they bring expertise, help to create new instruments and contribute in this way to the broadening of the financial sector.

Savings mobilisation

One important donor policy orientation should consist of supporting increased mobilisation of savings. This will allow the use of domestic resources available for investment as a whole, as well as helping the poor to accumulate more savings on a secured basis. To this end, donors can help to structure and develop financial markets by supporting specialised financial intermediaries and institutional investors (e.g. collective savings management instruments, life and pension insurance, pension funds).

Remittances

Migrants contribute in an important way to the informal and formal financial sectors in their country of origin. The whole system (banking, savings, and credits) needs to be adapted to allow them to contribute to the fight against poverty. A significant proportion of immigrants in host countries as well as their families in home countries remain “unbanked”. Therefore, one of the major challenges confronting traditional financial institutions and other financial service providers is to integrate unbanked senders and receivers into the financial system through better outreach, new technologies and more cost-efficient and transparent services.

CGAP principles

The Consultative Group to Assist the Poor (CGAP) have developed a set of Key Principles of Microfinance⁶ that provide good practices for the sound development of microfinance and which most donors follow. Under these principles, three important orientations should be given particular attention. The first is the promotion of a favourable legal and institutional environment. In this respect, it is important to support the efforts of national and regional monetary authorities to develop appropriate legal and regulatory frameworks for microfinance. Second, donors should help to consolidate existing financially viable microfinance institutions with the aim of helping them to attain a critical mass and to increase their number of beneficiaries. Third, it is advisable to promote linkages between microfinance institutions and banks to capitalise on their synergies and draw on the different skills and capabilities of each.⁷

PRSPs and financial sector policies

Notwithstanding the general recognition that the development of the financial sector is important for growth and poverty alleviation, the coverage of financial sector policies in Poverty Reduction Strategy Papers (PRSPs) is very uneven and a number of PRSPs cover financial sector issues only marginally or even not at all. This calls for additional dialogue between donors and partner countries in order to raise awareness and identify objectives at the policy level.

Conclusions

In addition to the more traditional focus of financial sector policy makers and regulators on efficiency and stability, it is important to realise that the financial sector plays a central role in enabling the poor to participate in and take advantage of economic growth. This paper highlights the importance of focusing on ways to promote wider access to financial services for the poor. In doing so, donors will help to open up the financial sector by the provision of new funding mechanisms and the encouragement of new financial activities.

In designing such strategies, donors should consider the following priorities:

- i) Encourage the collection of data on levels of access to financial services, barriers to widening access and the scale and nature of unmet demand.
- ii) Encourage greater professionalism in supervisory authorities and market regulators and help with the implementation of international financial standards and codes.
- iii) Strengthen financial intermediaries and help them to find sound instruments to serve sectors where returns are low or deferred.

- iv) Play a catalytic role by structuring specific financing schemes to attract other investors or by bringing expertise, helping in the creation of new instruments.
- v) Support an increased mobilisation and prudent intermediation of savings.
- vi) Bridge the gap between microfinance institutions and the formal banking system.
- vii) Encourage partner countries to cover financial sector issues in PRSP documents.

Notes

1. S. Rutherford (2002), "Money Talks: Conversations with Poor Households about Managing Money", Finance and Development Research Programme Working Papers series No. 45, IDPM University of Manchester; O. Ruthven (2001), "Money mosaics: Financial Choice and Strategy in a New Delhi Squatter Settlement", Finance and Development Research Programme Working Papers series No. 32, IDPM University of Manchester.
2. For instance: Beck et al. (2004), "Finance, inequality, and poverty : cross-country evidence", World Bank Policy, Research Paper No. WPS3338, 2004; "The importance of financial sector development for growth and poverty reduction", DFID, August 2004.
3. AFD (French Development Agency) (2005), "Microfinance", in *Parole d'Acteurs (Key players' views)*, No. 4.
4. DFID (2005), *Do credit guarantees lead to improved access to financial services?*, London.
5. A related controversial issue pertains to the treatment of guarantees in ODA accounting. Guarantees are counted as ODA only when the risk occurs (such as in the event of default), and when the guarantee is called. Considering the role of guarantees, at least as an accelerator of financial sector deepening, and more generally to leverage private local and foreign capital to finance private investment in developing countries, this accounting system underestimates the role of guarantees as a development instrument. It even may have a disincentive effect on donors in the present context of increasing ODA flows. Several DAC members have proposed changing how guarantees are recorded in DAC statistics but there is no consensus to modify the current system.
6. CGAP (Consultative Group to Assist the Poor) and World Bank (December, 2004), *Building Inclusive Financial Systems: Donors Guideline on Good Practice in Microfinance*.
7. CGAP (September 2004), "Breaking Down the Walls between Microfinance and the Formal Financial System", *Finance and Development*, No. 41, No. 2, Littlefield and Rosenberg.

Further reading

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- UNCTAD (United Nations Conference on Trade and Development) (2001), *Finance and e-finance for SMEs as a means to enhance their operations and competitiveness*, issues paper by the secretariat.