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Assessing the direct effect of financial development on poverty reduction in a panel of low- and middle-income countries

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ABSTRACT

This paper empirically assesses the directly contribution of financial development to poverty reduction in 67 low- and middle-income countries over the period 1986–2012. The main goal of the paper is to identify and quantify the channels through which financial development affects poverty. The results obtained suggest the important contribution of financial development to the reduction of poverty, and this, independently of the econometric techniques used. On the other hand, instability related to the financial development would penalize the poor population and would annihilate the positive effects of financial development. The final battery of tests is motivated by the issues of overidentification and weak instruments in system-GMM estimator. The results show the validity of the exclusion restrictions and the absence of instrument proliferation. Also, they may call into question the pro-poor public investment policy in low- and middle-income countries.

1. Introduction

The battle against poverty is considered as one of the main objectives of the development policies and strategies. Consequently, international institutions such as World Bank, IMF, OECD, etc. direct their policies and efforts toward the reduction of poverty.

It is largely allowed that the economic growth is one of the engines intervening in the reduction of poverty. However, it should be stressed that in some countries the benefit of the growth are reduced or destroyed by the increase in inequalities. Indeed, many factors which are considered by the literature as affecting the economic growth, such as macroeconomic stability, economic and trade openness, public expenditure, legal rules and civil liberty, political stability, financial development etc., can also influence the share of the income of the poor in the national income. Regarding financial development, an extensive literature shows that even if it boosts the growth rate of aggregate per capita GDP, this does not necessarily

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imply that it helps the poor. Financial development can increase average growth only by increasing the incomes of the rich and hence by increasing income inequality, then financial development will not help those with lower incomes.

The objective of the international community is to make the economic growth more favorable to the poor (the pro-poor growth), and thus due to specific public interventions, in the fields of health, education and productivity in the rural areas (Dollar and Kraay, 2002). The supply of financial services adapted to the poor occupies a dominating place in this strategy.

Stiglitz (1998) likens the financial system to the "brain" of the economy, performing the task of allocating resources across space and time in an environment of uncertainty. From this point of view, the financial development can contribute directly to the reduction of poverty by improving deposit and credit facilities offered to the poor and by optimizing resources allocation. Thus, the contribution of the financial development to the growth is exerted, on the one hand, through the influence exerted by the financial system on the intensity of exchanges and trade and, on the other hand, through the volume and the quality of the investment by the allocation of capital to their most productive uses. The effective utilization of domestic resources is crucial for generating economic growth and reducing poverty.

Some economic models, therefore, show that financial development reduces poverty directly, by disproportionately relaxing credit constraints on the poor by offering better and cheaper services for saving money and making payments, and indirectly, by improving the allocation of capital and accelerating growth.

Theoretically, the indirect effect of the financial development on poverty was studied in a dichotomous way. A first set of works finds a positive correlation between the financial development and the economic growth (King and Levine, 1993; Levine, 1997; Khan and Senhadji, 2000; Levine, 2004; Federici and Caprioli, 2009; Kabir et al., 2011; Barajas et al., 2013, etc.). A second one however finds an increasing relation between the evolution of the average income and the income of the poor (Ravallion, 2001; Bruno et al., 1998; Dollar and Kraay, 2002; Norton, 2002). Financial development produces faster economic growth, but it has been unclear whether it also shrinks poverty. Researchers have not determined whether financial development benefits the whole population, whether it primarily benefits the rich, or whether it disproportionately helps the poor. The impact differs across regions, income levels, and types of economy (developed vs. developing).

The credit belongs to Jalilian and Kirkpatrick (2005), Kpodar (2006), Honohan (2004), Beck and Levine (2004) who were the first to be interested by explaining the direct and indirect impacts of the financial development on poverty.

Many other studies have attempted to provide a theoretical and empirical explanations of a such relationship (Beck et al., 2007a; Honohan and Beck, 2007; Odhiambo, 2009, 2010a,b; Zhuang et al., 2009; Jeanneney and Kpodar, 2011; Jahan and McDonald, 2011; Khan et al., 2012; Uddin et al., 2014 among others). The main conclusions from these studies are that the deepening and the development of the financial sector lead to a reduction in inequality and poverty.

In an interesting paper, Odhiambo (2009) has shown that financial development contributes to poverty reduction in many ways. First, it can improve the access of the poor to formal finance by addressing the causes of financial market imperfections such as informational asymmetries, transaction costs, and contract enforcement costs (Stiglitz, 1998). These credit constraints will impede the flow of capital to poor individuals with high-return projects. Second, financial development enables the poor to draw down accumulated savings or to borrow money to start microenterprises, which eventually leads to wider access to financial services, generates more employment and higher incomes and thereby reduces poverty. Finally, financial development may trickle down to the poor through its influence on economic growth. This is because of the implied positive relationship between financial development and economic growth. According to the trickle-down theory, Aghion and Bolton (1997) have shown that as more capital is accumulated in the economy more funds may be available to the poor for investment purposes. This could contribute to the reduction of poverty. The trickle-down theory has been widely supported by many studies such as Fan et al. (2000), Ravallion and Datt (2002), Norton (2002) and Dollar and Kraay (2002), among others.

According to Zhuang et al. (2009) the most important channel through which financial sector development directly affects poverty is increased access to financial services. These services facilitate transactions, cut the costs of remitting funds, and provide the opportunity to accumulate assets and smooth incomes. Financial services can also help firms and households cope with economic shocks reducing their vulnerability to adverse situations, thus mitigating the risk to fall into poverty (Claessens and Feijen, 2006).

In this context, this paper empirically examines the direct effect of financial development on poverty reduction for a panel of 67 low- and middle-income countries over the period 1986–2012 using system GMM regressions. This issue is of importance for developing economies given the role of financial sector in mobilizing and allocating savings into productive investments. Furthermore, while they have much lower levels of financial depth, the low- and middle-income countries are experiencing financial deepening at rates far faster than higher-income countries. Over the period 2004–2009, cumulative average growth of private credit-to-GDP ratios in low- and middle-income countries was about 63% comparing with 33% for all other income groups (Jahan and McDonald, 2011).

This paper contributes to the literature in several ways. First, it tries to capture the direct effect of the financial development on poverty reduction. Second, it examines in particular the role of financial instability. Third, it looks specifically at low- and middle-income countries reaching more conclusive results on the role of financial development to poverty reduction.

Finally, it takes into account the problems of instrument proliferation, weak instruments and underidentification introduced in the literature by Roodman (2009a).

The remainder of the paper is organized as follows. Section 2 outlines the literature review of the relationship between financial development and/or financial instability and poverty. The data and the underlying methodology are introduced in Section 3. Section 4 reports and discusses empirical findings and Section 5 concludes the paper.