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## Finance is good for the poor but it depends where you live

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### ABSTRACT

I examine whether or not the incomes of the poor systematically grow with average incomes, and whether financial development enhances the incomes of the poorest quintile. Following the methodology of Dollar and Kraay (2002), I find, once extending Dollar and Kraay's data, their findings are robust to the Lucas critique and economic growth is important for poverty reduction universally. However, in comparison to other authors' work I show financial development aids the incomes of the poor in certain regions, whilst it may be detrimental in others. This proposes evidence against a "one size fits all" model adding a further contribution to the literature on financial development and poverty.

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### 1. Introduction

Since the turn of the millennium, and up until the financial crisis, growth of the world economy has been relatively strong. Growth with equity is a challenge that most governments have tried to establish with sceptics suggesting both cannot be accomplished simultaneously. Dollar and Kraay (2002) in an influential paper asked; "does the per capita income growth of the poor rise proportionally, less than proportionally, or more than proportionally to average per capita income growth?" their findings suggest that this is the case, hence emphasise the importance of economic growth for poverty reduction.

If growth is good for the poor, then growth enhancing policies should be encouraged. Literature suggests that certain policies and institutions exist that may further stimulate economic growth. In their paper, Dollar and Kraay suggest that trade openness, government consumption, the inflation rate, the rule of law and financial development may influence economic growth. Furthermore, a claim laid down is that these policies may even accrue or offset the income growth of the poor.

This is not to suggest that further factors may influence the economic growth process. Education is one tool that has been attributed to growth amongst others.

A rough battery of empirical evidence supports Dollar and Kraay's suggestions, in which openness to trade has been found to increase long run GDP per capita growth. Using the Sachs Warner index as a measure of openness, Greenaway et al. (1998) find that when this indicator variable takes the value of one highlighting an open economy, growth may be increased by 46%.

Easterly and Rebelo (1993) report that government consumption is harmful to growth; however, Dowrick (1996) shows that government consumption may be growth enhancing if it is maintained between a region of 10–18%. There is substantial evidence that inflation is harmful to growth. Barro (1996a,b) finds that an increase in inflation of ten percentage points retards growth by 0.2–0.3% hence over a thirty year period growth may be reduced up to 7%. Examining past work on the role of strong property rights and/or rule of law Knack and Keefer (1995) mention their importance for growth while Barro (1996a,b) empirically tests this hypothesis finding a strong legal system is required for favourable growth rates.

The literature on financial development and economic growth is extremely rich where early theoretical suggestions such as those by Schumpeter (1911) highlight the importance of finance for economic growth. Critics have challenged this view, suggesting finance merely follows growth, Robinson (1962). King and Levine (1993) in their interestingly titled paper "Schumpeter might be right" test these theories empirically and find that finance may cause economic growth. Moreover, the paper's results have since been complemented by further studies, including time series approaches and those of panel data from authors such as Arestis and Demetriades (1997), Luintel and Khan (1999), Levine et al. (2000) and Levine (2003).

Recently, Rousseau and Wachtel (2005) examine whether or not the finance-growth nexus has become extinct. The authors take the King and Levine (1993) data and thoroughly examine the robustness of this relationship finding that the results fail to carry over when more data is added to the research question. On closer inspection they find, when splitting the sample into 5 year periods, the 1970s and early 1980s were the main drivers of the

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relationship, hence from 1990 onwards the data was susceptible to the Lucas critique.

If financial development is no longer growth enhancing as the results from Rousseau and Wachtel seem to suggest, a question emerges; does financial development still benefit the poor?

If finance is available to the poor, then it may provide the poor with a means to save. In less developed countries (LDCs) cases exist where money is stored under a mattress, which may be problematic and hamper a household's ability to move up the social ladder. First, this money is vulnerable to theft, and keeping track of where all the money is hidden within a household is challenging. Second, during periods of macroeconomic instability, which may include periods of hyperinflation, savings accounts which are indexed to inflation may prevent this money from eroding away in value, a benefit for the poor. With a lack of savings accounts the poor may waste accumulated assets on the purchase of unnecessary physical capital, for example oxen for farming. These physical assets do not improve productivity or offer any major returns to the poor; they are just purchased for their ease of monitoring/storage and are highly illiquid when acquired. Moreover the presence of savings accounts may prevent transitory poverty by providing opportunities to utilise savings and consumption smooth during difficult times.

Furthermore, savings accounts in financial institutions may help the poor as accumulated savings over a generation may allow a family's offspring to pay for, and attain higher levels of formal education if parents are altruistic. This allows inter-generational mobility through the classes to be established more easily.

If we assume a fixed cost to be an entrepreneur, with perfect financial markets, a poor entrepreneur could go to a bank, highlight his business plan, and the ability of financial institutions to monitor and recognise good investments may allow poor entrepreneurs (those with the greatest entrepreneurial ability and the most talent) to have society's funds directed to them, as opposed to those with average ideas and existing wealth/established connections/collateral to take out a loan. This provides the necessary opportunities for the poor to move up the social ladder.

Research on finance and poverty alleviation is more recent and in its infancy compared to studies on finance and aggregate growth. Claessens and Perotti (2007) provide a summary of the existing literature, where Beck et al. (2007) discover fascinating empirical results.

Beck et al. (2007) complement the study of Dollar and Kraay (2002) with a stricter focus on the impact of financial development on poverty, specifically examining the Gini coefficient, the income share of the poor, and the percentage of people living on less than \$1 a day.<sup>1</sup> Their conclusions indicate that financial development is poverty reducing. Furthermore, they find that 40% of income growth from the poorest quintile is a result of reductions in inequality, but 60% due to the impact of financial development on aggregate growth. Hence, not only is financial development in their study positively associated with income growth of the poor, but their results suggest, that financial sector reforms, which reduce market frictions may also lower inequality, without the incentive problems which redistribution schemes that include generous social security payments create.

Hence I do not just focus on finance and its effects on poverty, but I consider whether or not aggregate growth has an impact on the poor in tandem. The motivation of this study is to examine first whether, unlike the results found by Rousseau and Wachtel on the finance-growth nexus, do Dollar and Kraay's (2002) findings remain with the inclusion of more data.

Second, I complement the Beck et al. (2007) study by using additional measures of financial development such as those used by King and Levine (1993) which were found to break down by Rousseau and Wachtel (2005) when modern data was included. Moreover, I choose to include a market based measure of financial development in the hope to prove that for poverty reduction it is just the overall level of financial development that matters, regardless of whether the development comes from the bank side or the market side. In addition, I choose to strictly follow the Dollar and Kraay methodology in the hope that the relationship between finance and poverty proposed by Beck et al. (2007) withstands further scrutiny.

This study, when including further data covers over one hundred countries and spans over fifty years. I expect to find that growth is good for the poor, and my results are at least as significant as those provided by Dollar and Kraay (2002). Furthermore, I aim to add to the Beck et al. (2007) study and show that financial development is imperative to the income growth of the poor, irrelevant of the financial development indicator used.<sup>2</sup>

## 2. Data and methodology

The original data is from Dollar and Kraay (2002), available to download from The World Bank.<sup>3</sup> The extended dataset comes from World Bank databases with information and definitions found in Table A of the appendix.

The dependent variable income growth of the poor is measured as the GDP per capita growth of the income of the lowest quintile.<sup>4</sup> This measure is used as it is consistent with the study of Dollar and Kraay, which I am trying to extend and check who's initial results hold, but also because it is a variable that is abundant.<sup>5</sup>

Financial development in this instance is measured as the depth of the financial system. Ideally, further measures that show the outreach of the financial system (breadth) would be useful, for example data showing the amount of access the finance system provides, but sadly due to data scarcity this cannot be accomplished. Private Credit as a ratio of GDP is one of the most frequently used measures of financial development and measures the channelling of savers' funds to private projects, one main function of financial intermediaries. This variable was used by Beck et al. (2007) in their own particular extension of Dollar and Kraay.

Further measures of financial development are also well used in the literature. King and Levine (1993) use Liquid Liabilities as a ratio of GDP.<sup>6</sup> This variable was found to be significant in the study of King and Levine (1993) on aggregate growth but became insignificant in the Rousseau and Wachtel (2005) paper when they extended the former authors' data. Hence I choose to include this measure of financial development due to the interesting experiences this variable has shown in the literature.

I incorporate a market measure of financial development. The chosen variable is Stock Market Capitalisation. Empirical results suggest that stock markets may increase growth, Levine and Zervos (1998), with further conclusions from the authors highlighting that banks provide different services than those provided by stock mar-

<sup>2</sup> Financial development is defined in the next section, as are the ways it is measured.

<sup>3</sup> [www.worldbank.org/research/growth](http://www.worldbank.org/research/growth).

<sup>4</sup> For the new waves of data I use and agglomerate the UN-WIDER Inequality Database <http://www.wider.unu.edu/research/Database> to calculate the new income shares.

<sup>5</sup> As there is limited data on further measures of the poor such as the headcount ratio it may not be worthwhile examining these variables as observations would be extremely low.

<sup>6</sup> Liquid liabilities is measured as M3 as a ratio of GDP and is also known as broad money. It measures the overall size of the banking system. Hence it shows the extent of the formal financial intermediary sector relative to economic activity.

<sup>1</sup> Recent updates state the new poverty line is \$1.25 a day as suggested by Ravallion et al. (2008) "Dollar a day revisited."

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