POLICY OPTIONS AND CHALLENGES
FOR DEVELOPING ASIA—
PERSPECTIVES FROM THE IMF AND ASIA
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COMMENTS ON:
BECK, DEMIRGÜÇ-KUNT & LEVINE, "FINANCE, INEQUALITY AND THE POOR"

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Main findings of the paper

- Positive cross-country relationships between:
  - financial development (FD) and greater income equality
  - FD and poverty reduction
- thus, *no* trade-off between growth & equity in FD (FD is unambiguously pro-poor)

some questions for policy makers (given this paper's results)

- How robust is the <u>quantitative</u> magnitude found (i.e., the importance of financial development (FD) for equity/poverty reduction)?
- So what? Moving toward more concrete policy implications (what else do we need to know to identify policy instruments?):
  - What do theories say about pro-poor FD?
  - Some insights from country-level studies
    - Complementarity between FD and public investments
    - Potential caveats in pursuing FD?

How robust are the findings on the quantitative importance of FD? (1)

- Cross-country studies:
  - Within-sample robustness checks
  - Clarke et al (2006)
  - Kraay, JDE (2006)?:
    - decomposition of poverty reduction into growth vs. via income redistribution components→ sensitive to data?:

      *poverty reduction = mean income growth('short run':70%, 'long run':97%) + change in income distribution ('short run':30%, 'long run':3%)
    - no significant effect of FD (M2/GDP) on growth nor change in Gini

How robust are the findings on the quantitative importance of FD? (2)

- country-level studies finding substantial impact of financial development on growth/poverty reduction
  - (Binswanger, Khandker & Rosenzweig, JDE, 1993; on India) Impact of FD on:
    - ag. investments: milk animals(0.8), draft animals(0.5), pumps(0.4)
    - fertilizer demand (0.2)
    - crop production (0.02)
  - (Townsend, 2006; on Thailand) FD was a major source of income growth and poverty reduction mainly by
    - helping household/small enterprises (starting or/& expanding business), and
    - raising wages (60% ↑)

Toward policy implications? (1): What do theories say? (A)

- Contrasting predictions of alternative models may not be as contradictory as they seem? → different aspects of 'financial development' (FD):e.g,. intensive vs. extensive margin?
- models with <u>exogenous</u> credit market failures (e.g., Galor & Zeira 1993, Banerjee & Newman 1994, etc.): relaxing credit constraints (extensive margin) is pro-poor
- Greenwood & Jovanovic,1990 (a model with <u>endogenous</u> FD): FD in intensive margin is anti-poor

→together theories imply:
'pro-poor' FD = extending access to financial intermediation toward poorer households

Toward policy implications? (2): What do theories say? (B)

- What are the barriers for the poor against entering financial intermediation?
  - Various sources of market failures: moral hazard, transactions cost, etc.
  - 'entry fee'?, connection? (← Greenwood & Jovanovic)
- This is an empirical question

Toward policy implications? (3): insights from country studies (A)

- What are the sources of financial market imperfection?
  - (Townsend, forthcoming, on Thailand): nature of credit constraint (thus potential remedies) may differ across regions (and across the wealth ladder among households)
- How can FD be facilitated?: complementary investments, microfinance, etc.
  - (Binswanger, Khandker & Rosenzweig 1993, on India): Determinants of expanding bank branches in rural areas (i.e., FD in extensive margin?) = market infrastructure (0.2) and road (0.8) [but not primary schools] as major determinants of expansion of commercial banks
  - (Binswanger, Khandker & Rosenzweig 1993, on India): availability of banks more important than interest rate
  - (Townsend, 2006): physical capital and human capital are complementary
  - (Townsend, 2006): mixed findings on village-level microfinance institutions

Toward policy implications? (4): insights from country studies (B)

- Potential caveats?
  - (Townsend, 2006): some business owners may suffer welfare losses due to wage increases via FD
  - (Fuwa, et al. 2006, on India)relaxing credit constraint may potentially (and temporarily?) increase gender disparity in schooling

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