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Financial Development Helps the Poor in Poor Countries

More financial development reduces poverty by easing credit constraints on the poor, reduces income inequality, and improves the allocation of capital.

For decades, politicians and economists have puzzled over how to alleviate severe poverty in the world more quickly. More than half of the world's inhabitants, 2.7 billion people, lived on less than $2 a day in 2001, and 1.1 billion lived on less than $1 a day.

One way to help, economists **Thorsten Beck**, **Asli Demirguc-Kunt**, and **Ross Levine** find, would be to encourage financial development in poorer nations. Their research, outlined in **Finance, Inequality, and Poverty: Cross Country Evidence** (NBER Working Paper No. 10979), indicates that increased financial development in a poor country induces the incomes of the poorest people in that nation to grow faster than the average per capita gross domestic product (GDP) -- that is, the nation's output of goods and services divided by its population. In turn, income inequality falls more rapidly, and poverty rates decrease at a faster rate, than would otherwise be the case.

For example, consider Brazil: the average income of the poor in Brazil would have grown at more than 1.5 percent per year instead of not at all from 1960-99 if Brazil had the same level of financial intermediary development as Korea.

These research results are somewhat of a surprise. Much of the economic literature finds that 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.

One theory suggests that financial market imperfections, such as inadequate information, transactions costs, and contract enforcement costs, may be especially binding on poor entrepreneurs who lack collateral, credit histories, and connections. Such credit constraints could impede the flow of capital to poor individuals with high-return projects, thereby intensifying inequality. So, more financial development reduces poverty by easing credit constraints on the poor, reduces income inequality, and improves the allocation of capital. It thereby accelerates economic growth.

Another theory, however, suggests that since the poor primarily rely on informal, family connections for capital, improvements in the formal financial sector primarily help the rich. At early stages of development, only the rich can afford to access and profit from financial markets. Thus financial development intensifies income inequality. If financial development increases average growth only by increasing the incomes of the rich, and hence increases income inequality, it may not lower poverty rates.

To assess the merits of these competing theories, the three authors analyze the impact of financial development on poverty alleviation in two ways, both involving comparisons between countries. First, they use data on the economies of 52 developing and developed nations, over the period 1960 to 1999, to test the relationship between financial development and changes in the distribution of income. Second, they use data on 58 developing countries for the period 1980 to 2000 to assess the direct relationship between financial development and poverty alleviation. Their data indicate that financial development reduces poverty by exerting a disproportionately positive effect on the poor.

To analyze financial development, the authors measure "private credit" which is defined as the value of credit by financial intermediaries to the private sector, divided by GDP. This measure excludes credit issued by the central bank, development banks, and credit to state-owned enterprises. Thus it captures the amount of credit channeled from savers, through financial intermediaries of all sorts, to private firms.

In one example, in Chile -- with a high private credit ratio of 54 percent -- the percentage of the population living on less than $1 a day shrank at an annual rate of 14 percent between 1987 and 2000. By contrast, Peru -- with a low private credit ratio of 13 percent -- saw the number of people living on $1-a-day increase at an annual rate of 19 percent. If Peru had had the same level of development among financial intermediaries as Chile, then the number of extremely poor people in the country would have increased at only 5 percent per year. So, the share of Peruvians living on less than $1 would have been about 2 percent in 2000 rather than the actual 15 percent.

"Thus," the authors note, "the impact of financial development on poverty is quite large." It lowers income inequality and boosts growth without the potential disincentives to entrepreneurs and others resulting from policies that directly redistribute income and other resources

-- David R. Francis

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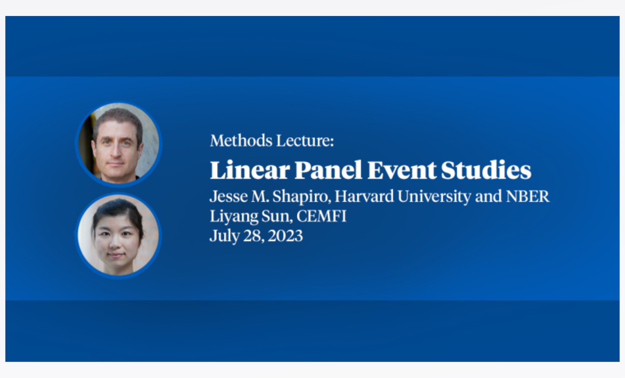

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