POLICY OPTIONS AND CHALLENGES
FOR DEVELOPING ASIA—
PERSPECTIVES FROM THE IMF AND ASIA
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FINANCE, INEQUALITY AND THE POOR

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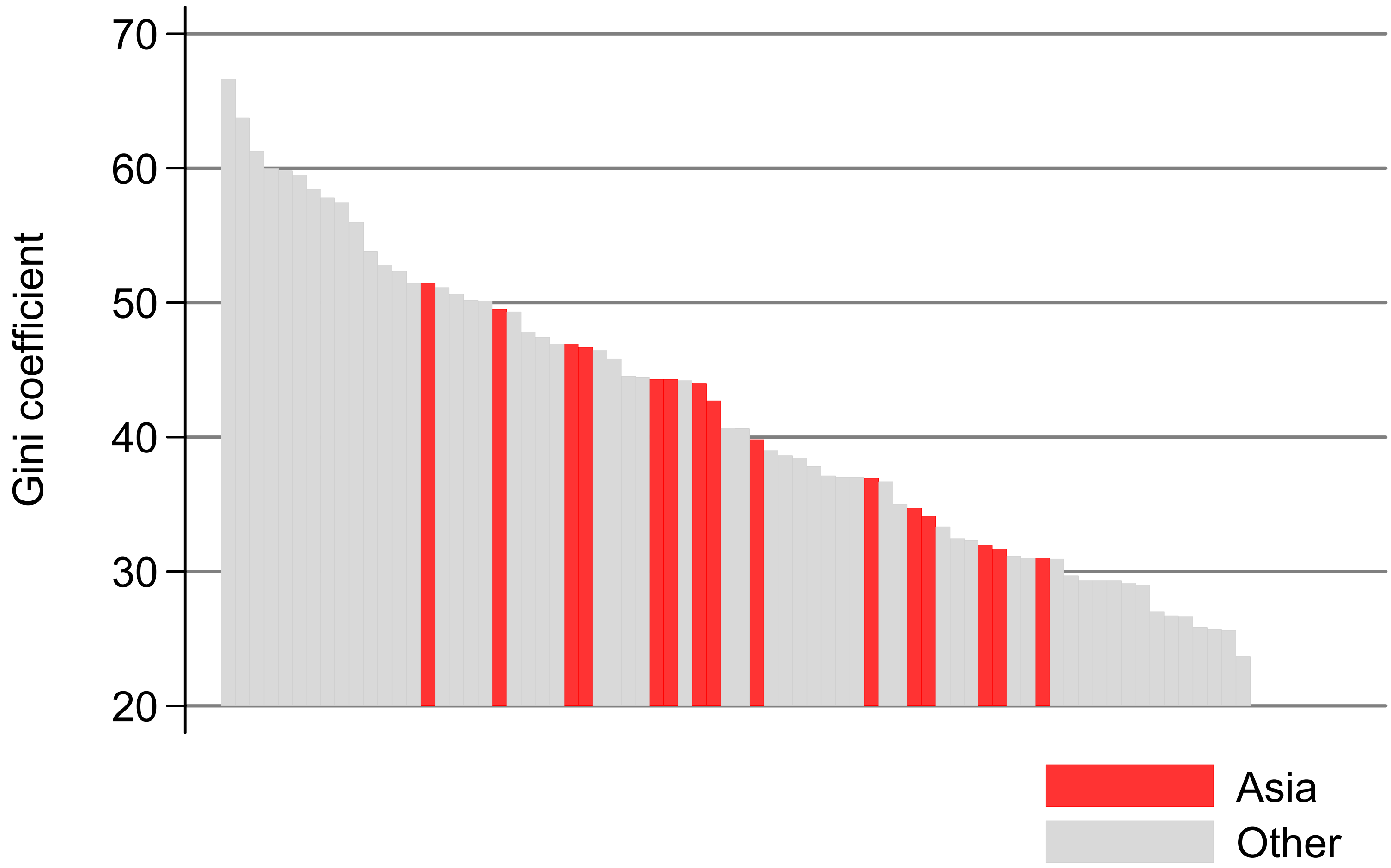
Finance, Inequality and the Poor

Thorsten Beck, Asli Demirguc-Kunt and Ross Levine

Motivation

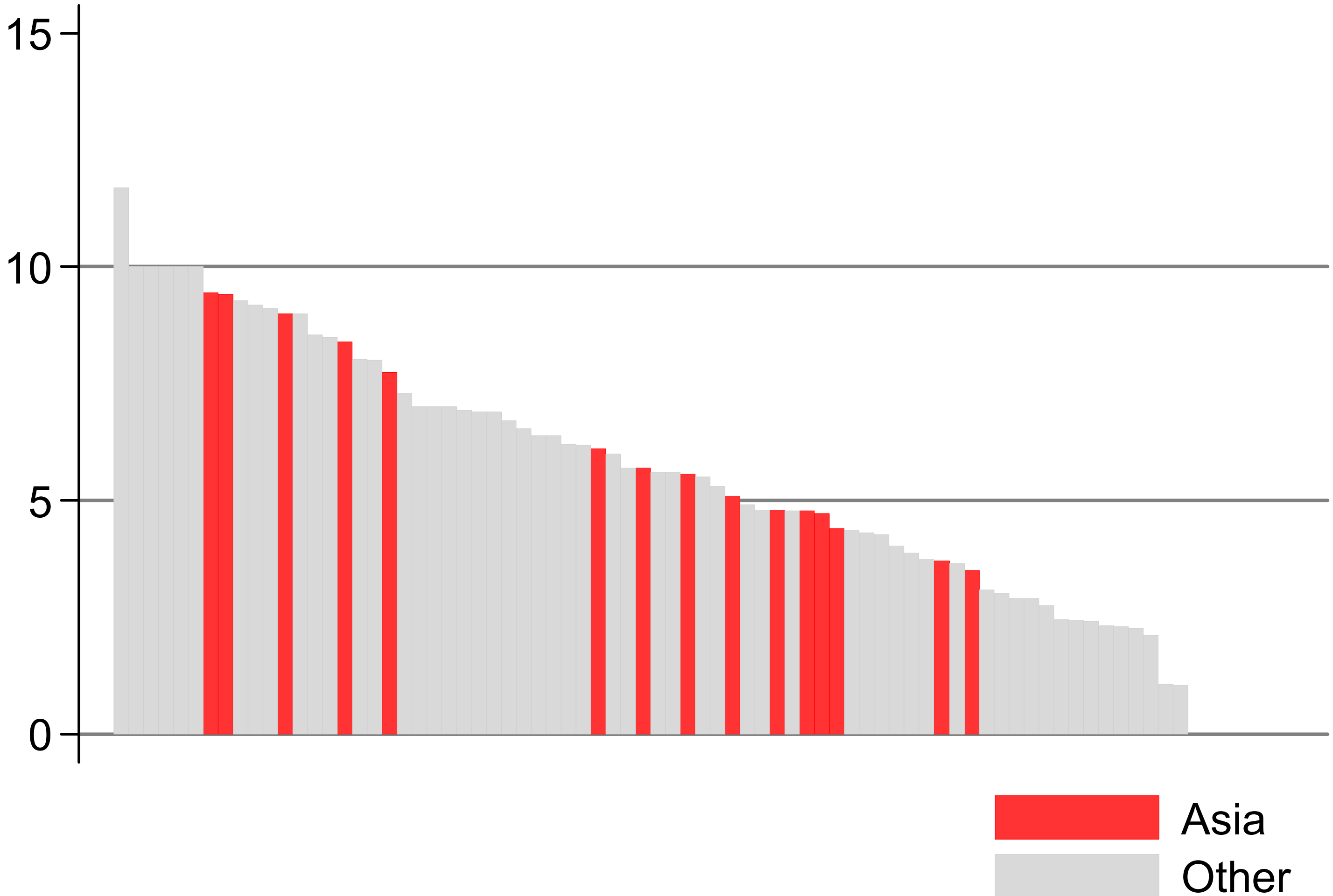
- Large variation in income inequality across countries – both in levels and in changes
- Finance is pro-growth, but who benefits? Is it also pro-poor? Is there a growth-distribution trade-off?
- Theory provides conflicting responses to this question

Gini coefficient across countries



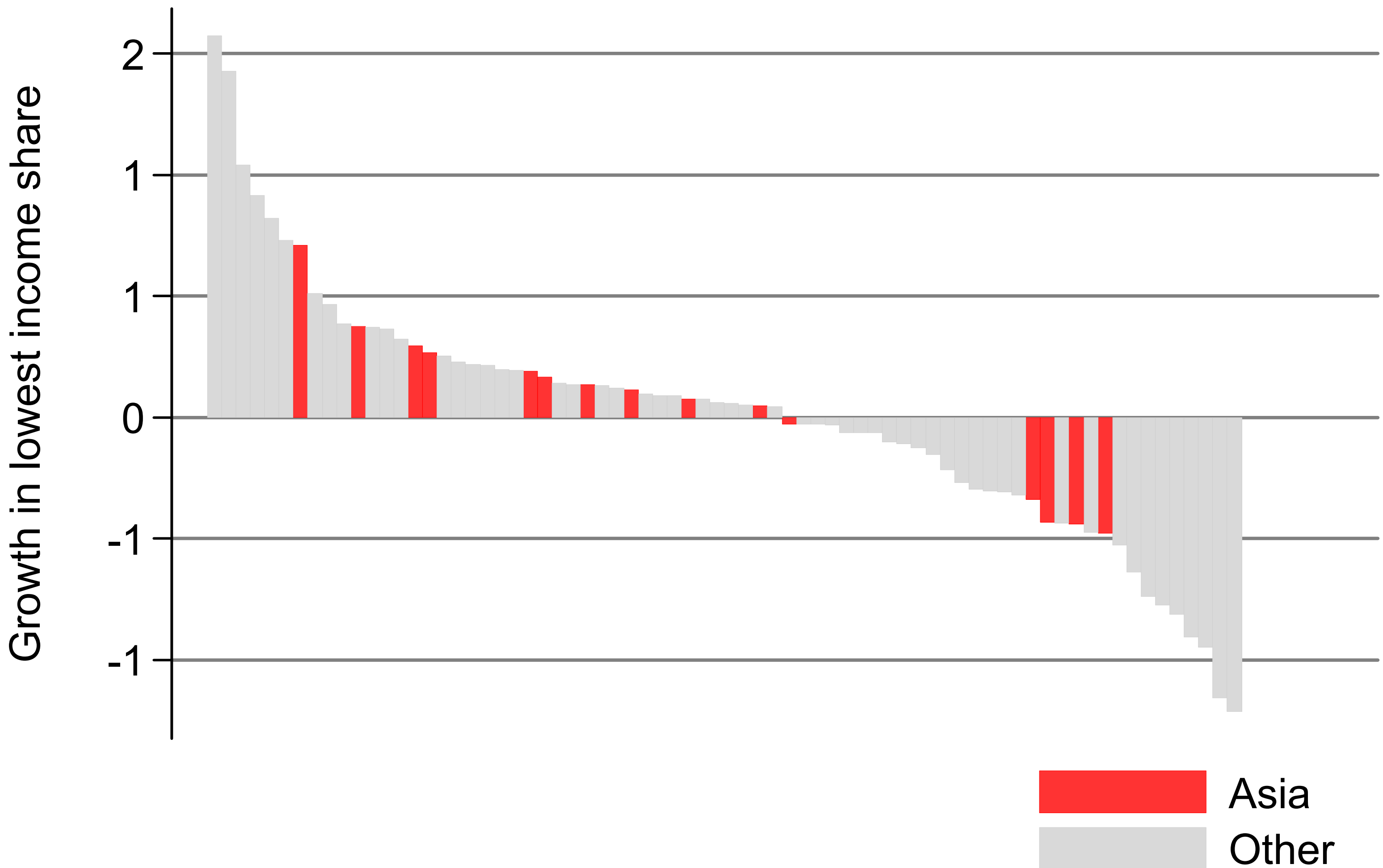
Sample size: 72 countries

Share of lowest income quintile across countries



Sample size: 72 countries

Growth in lowest income share across countries



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Finance and income inequality - Theory

- Pro-poor
  - Credit constraints are particularly binding for the poor
  - Finance helps overcome barriers of indivisible investment
  - Finance foster economy-wide openness and competition by facilitating entry
- Pro-rich:
  - Only rich can pay “entry fee” into financial system
  - Credit is channeled to incumbent and connected and not to entrepreneurs with best opportunities

Growth and income inequality – the role of financial constraints

- Negative relationship between inequality and growth often explained with financial market constraints; suggesting redistributive policies
- Alternative: financial sector reform that reduces market frictions, lowers income inequality and boosts growth without incentive problems of redistributive policies

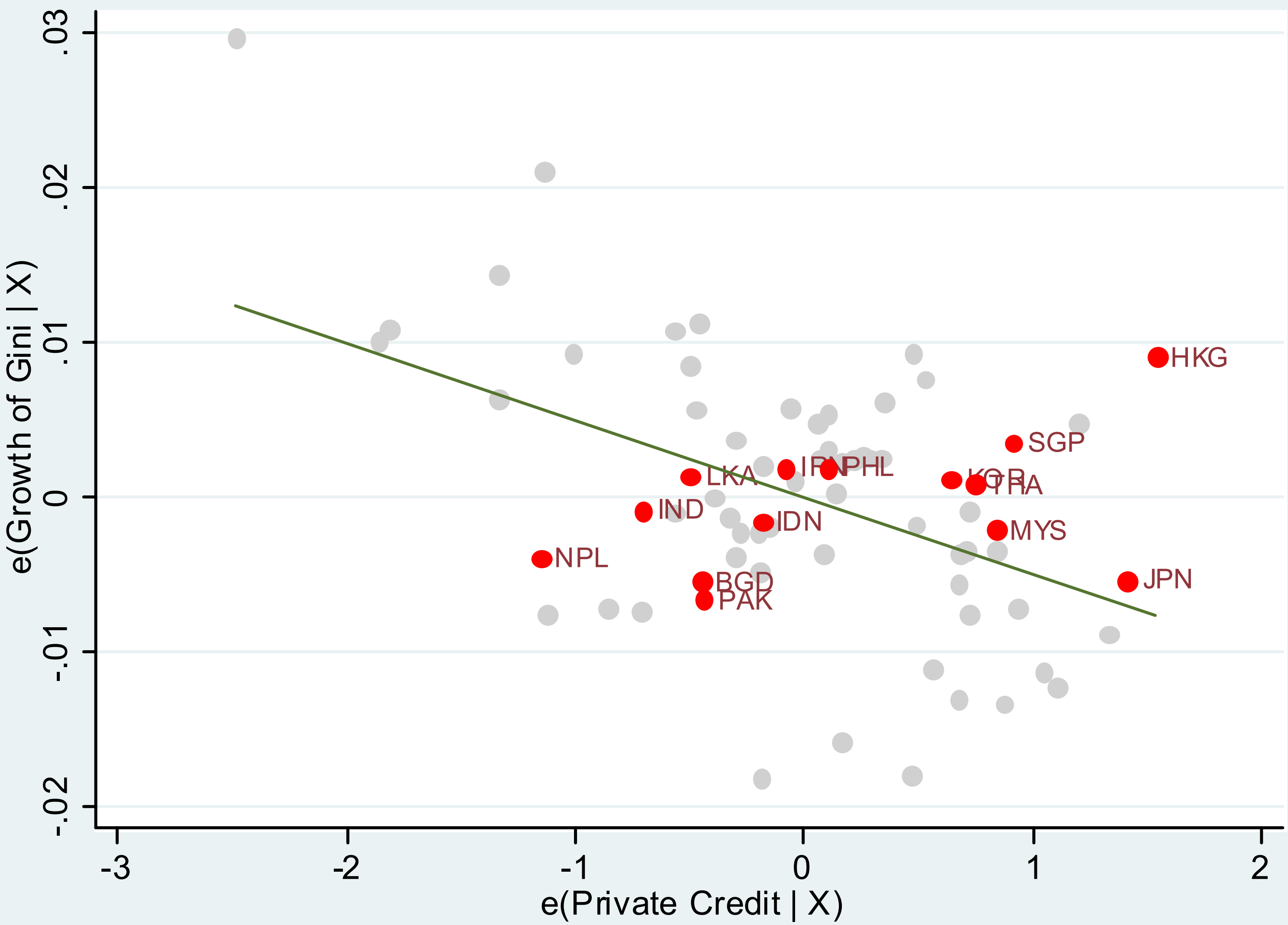
Finance, income inequality and poverty – our approach

- Finance and relative poverty
  - $Y_P = Y^*L(0.2)/0.2$
  - $g(Y_P) = g(Y) + g(L(0.2))$
  - Using cross-country data we assess the relationship between financial intermediary development and changes in income inequality – Gini coefficient and income share of lowest quintile
- Finance and absolute poverty:
  - Changes in poverty (headcount) can be decomposed into changes due to growth and due to income inequality

Finance and income inequality - data

- Private Credit
  - Value of credit by financial intermediaries to the private sector divided by GDP
  - Countries with higher levels of Private Credit grow faster (Beck, Levine and Loayza, 2000)
- Average annual growth rate of the income share of poorest quintile, 1960-2005
- Average annual growth rate of the Gini coefficient, 1960 – 2005
- Average annual growth rate in Headcount (population share living on less than one dollar a day), 1980 - 2005
- 72 countries

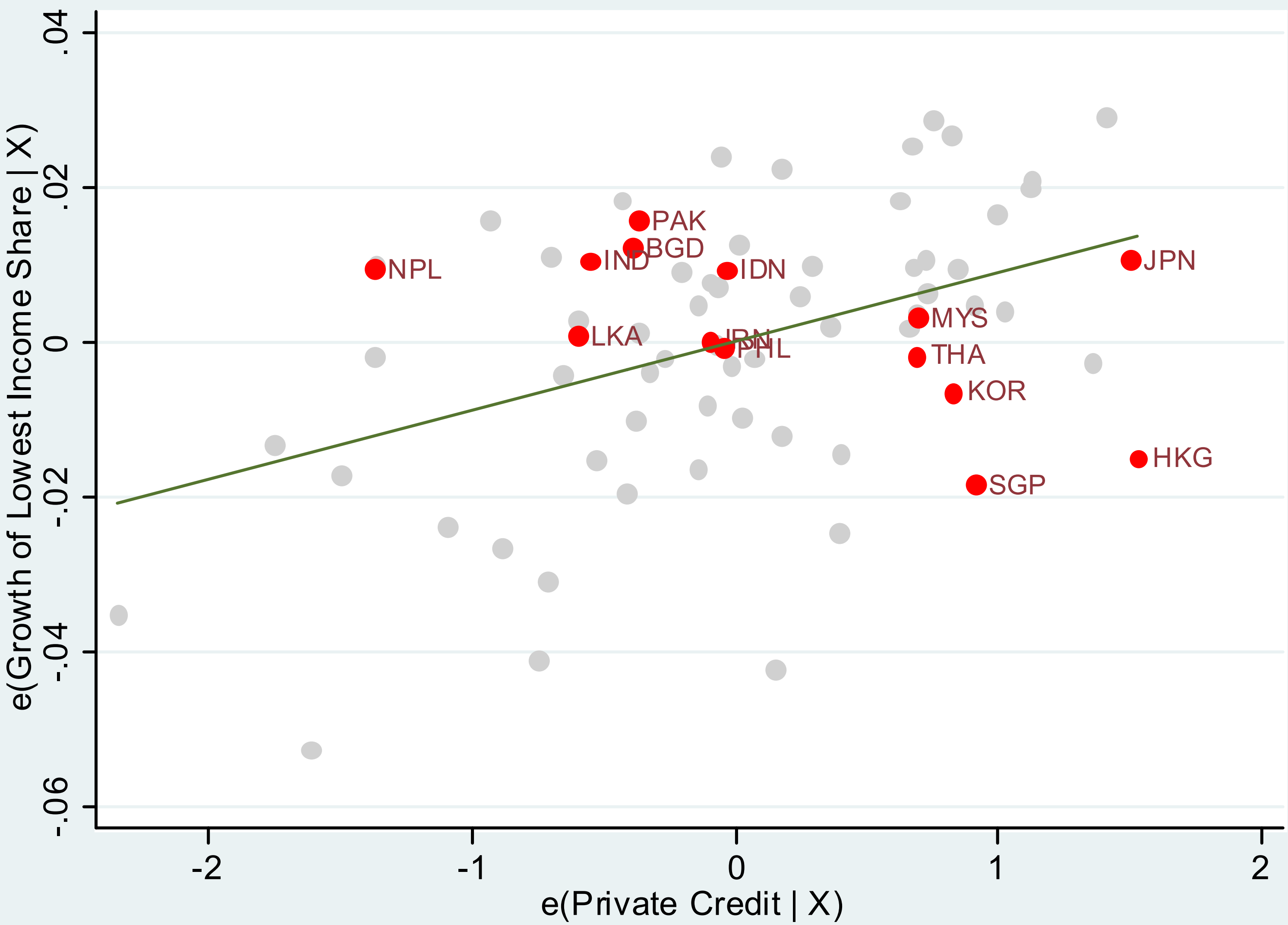
Finance and growth of Gini



Finance and Gini – robustness checks

- Controlling for other country characteristics
  - Schooling, Inflation, Trade Openness
  - GDP per capita growth
- Outlier tests
- Different sample periods
- Alternative indicator of financial development
- Dynamic Panel regressions

Finance and growth of lowest income share



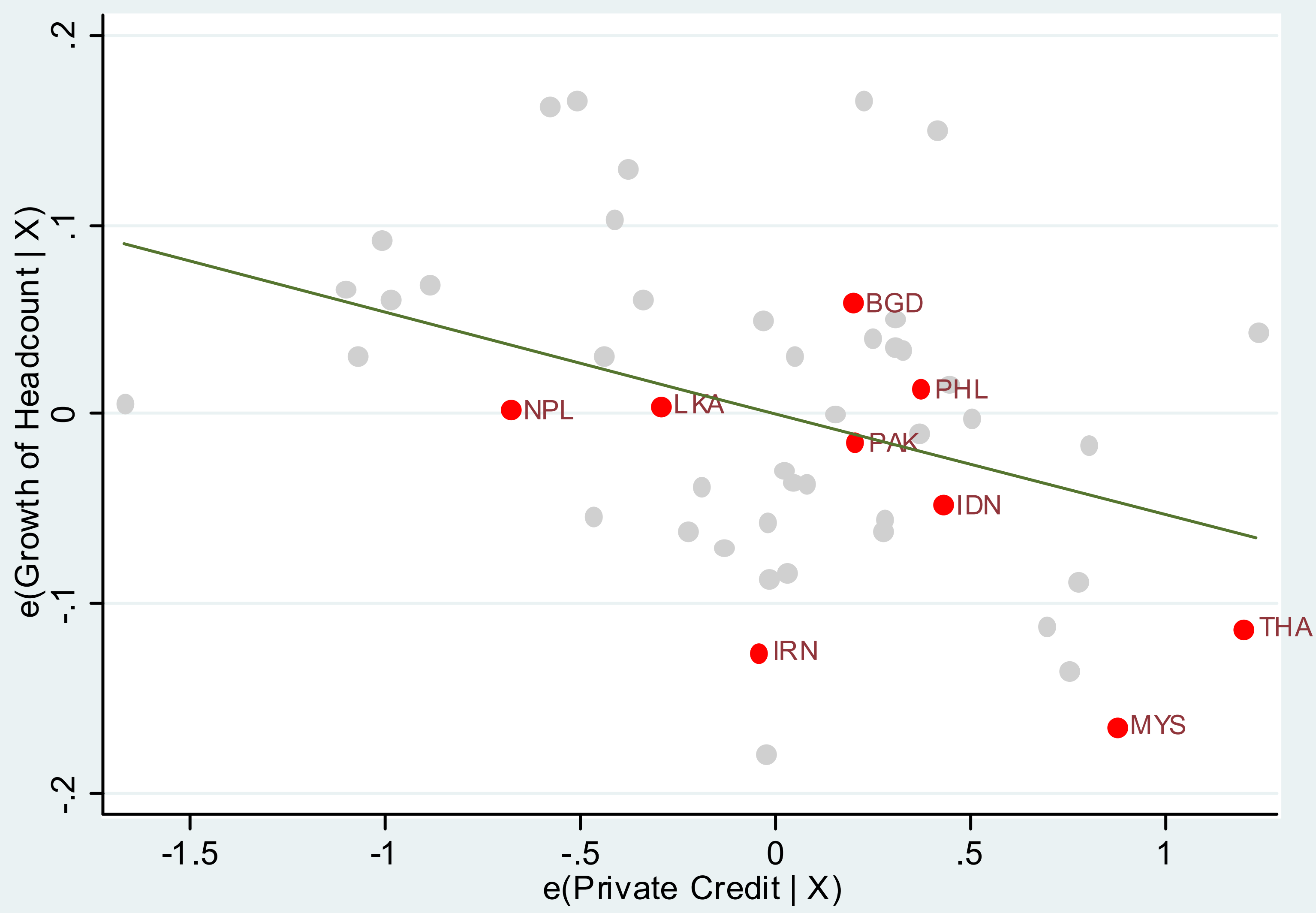
Finance and Income Inequality – the economic effect

- Compare Private Credit to GDP
  - Sri Lanka 16%
  - Malaysia 57%
- Had Sri Lanka had Private Credit to GDP level of Malaysia, its growth of lowest income share would have been 1.3% instead of actual 0.2% and the lowest income share in 2002 would have been 7.5% instead of the actual 4.8%.
- Notes of caution:
  - in-sample large change;
  - Result does not tell us how to increase financial development!

The effect of finance on the poor - growth effect vs. income inequality effect

- Cross-sectional comparison suggests that 60% of the effect of financial development on the income growth of the poorest quintile comes through growth and 40% through distributional effects
- Financial development raises all boats, but more those of the poor!
- There is no growth-distribution trade-off in financial sector reforms

Finance and Poverty Alleviation



Finance and Poverty Alleviation – the economic effect

- Compare Private Credit to GDP
  - Bangladesh 23%
  - Thailand 65%
- Had Bangladesh had Private Credit to GDP level of Thailand, its headcount would have fallen from 26% (1983) to 15% (2000) instead of increasing to 36%.
- Notes of caution:
  - in-sample large change;
  - Result does not tell us how to increase financial development!

Finance and Poverty Alleviation - growth effect vs. income inequality effect

- Both growth and distribution channels matter for effect of finance on poverty alleviation
- Stronger growth effect in poor and more equal societies
- Stronger distribution effect in rich and less equal societies

Finance and Income Inequality – Summary and implications

- Finance is pro-growth and pro-poor
- No trade-off between growth and distribution goals
- How to foster financial intermediary development?
- What are the channels?
  - Access to savings/payment services
  - Access to credit
  - Indirect effect: more competitive product and labor markets