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Reflections on current issues

Financial Development and the Unbanked

South African Reserve Bank

click on note

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Enquiries relating to this publication should be addressed to:

The Head of Research
Research Department
S A Reserve Bank
P O Box 427
Pretoria 0001
Tel. 27-12-3133668/3944

E-mail: Lebo.Lehutso-Phooko@resbank.co.za
http://www.resbank.co.za

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Editorial overview

South Africa's positive track record of macroeconomic management as well as steady economic growth in the face of a harsh global environment have boosted the international credit and investment ratings and the general business and consumer confidence. However, joblessness, poverty, the wealth gap and HIV/Aids continue to dampen the otherwise optimistic outlook.

It is in this context that this volume explores the theme of financial development and banking the 'unbanked'. The focus area is the extent to which financial development and accessibility offer a window of opportunity for reaching higher and more equitable economic growth and for tackling the frontiers of poverty.

There is general consensus that financial development and access to finance, especially among the marginalised, in the context of macroeconomic stability, are necessary elements for economic growth. Macroeconomic stability indirectly plays its role by fostering macroeconomic certainty, predictability and credibility. Financial development contributes, *inter alia*, to mobilisation of savings, facilitates risk diversification and pooling, enhances selection of the best investment opportunities and fosters corporate governance through its monitoring systems. Most pertinently, accessible financial services such as banking can assist poor and vulnerable households to hedge themselves against negative shocks such as loss of a job, death of a breadwinner or a natural disaster.

Although South Africa enjoys a well-developed financial sector by global standards, it is still inaccessible to a majority of domestic investors, the emerging small business sector and households. It appears that current debates question the appropriateness of the financial architecture for the under-serviced demand side, on the one hand, and the associated risk profile, on the other. The supply and demand challenges in financial development and access to financial services are linked and they require equal attention from researchers, the private sector, macro and microeconomic policy makers.

This volume consists of two articles. The first article explores pertinent issues related to financial development as a means to an end, rather than an end in itself. It is an overview of the challenges of measuring various dimensions of access, the current status of access to a range of financial products in the market and how the 'unbanked' cater for their unmet needs. It then concludes with pointers for policy and institutional development.

After reviewing the existing literature on the relationship between financial development, economic growth and poverty alleviation, the second article offers an international perspective on factors that hinder financial development and how they can be dealt with.

In addition to facilitating policy discourse and making research findings accessible to a wider readership, the *Labour Markets and Social Frontiers* series also contributes to sharing available data and information on various themes that it periodically covers. This issue includes an appendix consisting of a limited selection of indicators from available sources comparing the banked and 'unbanked' in South Africa.

Lead editor: M Lehutso-Phooko
Research Department
South African Reserve Bank

The landscape of access to financial services in South Africa

David Porteous
FinMark Trust, South Africa

Understanding the current landscape of access to financial services in South Africa is an essential starting point from which to consider the impact of potential policy changes on the future levels of access.

Expanded access to financial services is not in itself an ultimate goal, but rather an important objective en route to the broader goal of reducing poverty. On the one hand, financial services such as insurance or secure savings play an important part in ameliorating the effect of shocks to income caused by death, illness or weather conditions, hence reducing vulnerability to poverty. On the other hand, a sustainable route out of poverty usually includes the ability to take advantage of income generating opportunities and to build capital, whether human or otherwise, through investment of money over time.

The main objective of this paper is to benchmark the current levels of access to financial services in South Africa using the most recent available data. The concept of promoting greater access to financial services is widely accepted yet it is not easy to define precisely or to measure. The paper argues for a clearer definition of access, based on dimensions of physical access, product features and affordability. Information on adults who currently use at least one financial service product is broken down in terms of product types across Living Standard Measures (LSMs)[1]. The paper concludes by highlighting economic policy implications in the current debate on access to financial services in South Africa.

The concept of access

Access to financial services has become the dogma of the global microfinance movement, represented by the Consultative Group to Assist the Poor (CGAP) programme which defines microfinance as 'diverse institutions providing massive permanent access to a broad range of financial services for a broad range of clients.'[2] Wider access is an objective with broad acceptance across the political spectrum because it implies the ability (some may go further to say 'right') to use a service, without the obligation to use that service. Hence, there may be people with access but who choose not to exercise that access.

Box 1 Exploring the dimensions of access to financial services

Does the offering of a financial product through a bank branch which is a half-an-hour trip away from the place of residence of a consumer, constitute 'access' to that product for that consumer? Do the following circumstances affect the answer:

- When the consumer has a motor vehicle, so that the trip is easy to undertake?
- If a consumer does not have private transport and the cost of public transport is less than Rx or a specified percentage of income?
- If the bank branch were close to the place of work or place of regular shopping?

Seemingly these questions pose more complex physical dimensions to the challenge of access.

There are also issues related to the nature of the product offering:

- In cases of owner operated micro-enterprises, bank branches that open during normal banking hours become inaccessible.
- Also, the bulk of the cash flow from small payments of micro-enterprise businesses can be compromised if after hour options such as automated teller machines (ATMs) do not accept coins.

Furthermore, if the monthly cost to a consumer of operating a basic bank account were R40*, and the consumer is only prepared to pay R20 per month, does this constitute access, which the consumer is making a rational decision to deny on a cost-benefit basis? Or to ask it another way, can the issue of affordability be factored into access? There is a difference between a household earning R20 000 per month in which one spouse decides not to open an additional account, saving the R40, and depending on the other's account; and a household earning R800 per month in which no one has a formal financial product. But where should the line on affordability be drawn?

Affordability plays a key role in current usage patterns. Based on an average user profile, the current low end bank products cost around R40 per month in fees**. If the affordability level for transactions accounts were set at 2 per cent of gross household income, all households below LSM 4 (or 40 per cent of the population) would not have access.

* Average R/US$ exchange rate for March 2003 = R8,0450.

** FinMark Trust. 2002. *Unpublished survey collating bank information.* Johannesburg. Calculated using typical user profile including monthly: two debit orders, two ATM withdrawals, one SASWITCH withdrawal and one statement request.

1 LSMs are South Africa's most widely used market segmentation tool, dividing South African households into 10 groups. It is a move away from segmentation based purely on demographics or income. Essentially, the LSM is a wealth measure based on standard of living rather than income mainly associated with living conditions such as consumer durable ownership including cars and major household appliances and degree of urbanisation. It is less useful when applied to financial services, but is the best available simple segmentation tool.

2 Littlefield, E. 2002. Presentation to FinMark Forum. Available: www.finmarktrust.org.za

While the objective of greater access may itself be widely acceptable in principle, it is very difficult to measure accurately in practice. It is far easier to measure the number of current users of a particular financial service, as surveys can and do, but this number would undercount those who have access to the product category, but chose not to use it. Nevertheless, the number of users of a product gives the best currently available proxy for access, and it is these numbers which are reported later in this paper.

Measurement practicalities apart, the concept of access to financial services also requires a clear definition (as highlighted in Box 1) if it is to promote meaningful discussions about how to expand access.

The concept of access to financial services has several key dimensions, including:
- terms of the product offering: whether these preclude certain types or sizes of transaction;
- physical access: the distance to the nearest service point at which a service (such as acceptance or withdrawal of cash) can be undertaken, which may be measured in terms of time, distance and/or travel cost; and
- affordability: whether the cost of using a product is within the reach of the targeted consumer, based on defined norms.

Box 2 An example from the telecommunication sector in South Africa

In terms of the Telecommunications Act of 1996, a Universal Service Agency (USA) was established which is required to recommend to the Government what constitutes universal access to telecommunications services. The USA began a process of consultation in 1998/99. In the draft document*, the following definition is proposed:

'Universal access for voice telephony is a working telephone available 24 hours a day, seven days a week, within one km for rural areas and 200m in urban areas'. Against this standard for universal access, the USA then proposes targets for achievement of this standard by 2005. Standards and objectives are also proposed for universal service, which refers to private or household telephony. All houses are targeted to be fitted with telephone points within 10 years, improving on the 1997 level of 32 per cent of houses.

Finally, the USA administers a Universal Service Fund, comprised of levied contributions on telecommunication license holders, which is used exclusively to subsidise the cost of provision of services to needy persons (including financing operators under legal obligation to extend services to needy communities). The USA proposes that two per cent of household income be used as an affordable benchmark for access, and points out that at a basic cost of R30 per month, 44 per cent of households cannot afford a telephone. It should be noted, however, that the USA is still reportedly unable to provide accurate benchmarks on access, pending more detailed geographical information system data.

* Universal Service Agency (USA). 1999. *Universal access and service definition for South Africa*. Draft 2. November.

There is a need to define more explicitly what universal access would mean in the financial services sector, and to devise means of measuring more accurately the status of access in this sector.

Usage of transaction accounts

What are the levels of usage?

In 2001, 11 353 000 adult South Africans had at least one form of basic bank account[3]. This leaves 17,6 million adults who do not use a bank account of any sort. The approximately 40 per cent current usage level should be compared with other countries at similar and different levels of development:
- USA: 90 per cent[4]
- Brazil: 35 per cent (household basis)[5]
- Kenya: 5,9 per cent[6]

The distribution of bank accounts across LSMs, the most widely used market segmentation measure in South Africa, is shown in Figure 1. The pattern of bank account ownership correlates strongly with the LSMs, based largely on observable durable goods ownership, which in itself reflects income and education factors.

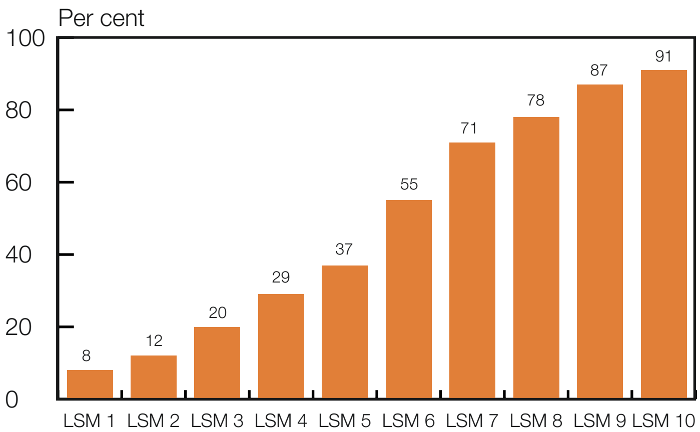
Who are the 'unbanked'?

An analysis of the market segments of the 17,6 million 'unbanked' South Africans has shown, *inter alia*, the following distinct groups[7]:
- *Economically active:* The 5,7 million economically active individuals who do not have bank accounts

3 ACNielsen. *FutureFact Marketscape Survey 2002.* Johannesburg.
4 Harlin, K. 2002. Banks court unbanked. *The Times Union*. April 28, 2002. Three Star Edition. Business Section. p. E1. Albany: New York.
5 Figures provided by Caixa Economico Federal of Brazil, Presentation to FinMark Forum 2002. Available: www.finmarktrust.org.za
6 Equity Building Society. 2002. Estimate given by managing director. Nairobi.
7 SAtoZ. 2002. Segmentation research done at the request of FinMark Trust. Unpublished. Johannesburg.

are found predominantly in the rural areas (35 per cent), informal shacks or settlements (25 per cent) and in the townships (24 per cent). Not all are unemployed: 21 per cent of this group work in full time or part time formal employment, some with large companies.
- *Pensioners:* 1,9 million people in this category without accounts, typically found in marginalised black rural communities. Their homes are shacks or informal settlements. They feel bypassed by society and live in a world of poverty and survival.
- *Students:* 2,9 million people over the age of 16 who are currently in secondary or tertiary education and who do not have bank accounts[8].

Figure 1 Adults with transaction account by LSM



Source: ACNielsen. *FutureFact Marketscape Survey 2002.* Johannesburg

Usage of savings

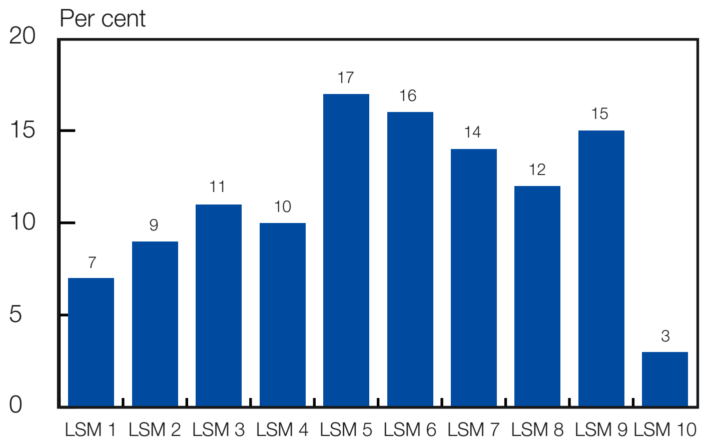
Levels

It is estimated that four of every five formally employed people (5,4 million) have access to a contractual savings mechanism such as a pension or provident fund. If one includes other savings mechanisms including informal Rotating Savings and Credit Associations (ROSCAs), then 12,7 million adults (44 per cent) make use of at least one type of savings product.

Informal savings mechanisms

Stokvels[9] are the country's most common form of ROSCA, although they differ in type. Some have more to do with income generation through staging events than with savings as such. The distribution of stokvel membership across LSMs is shown in Figure 2.

Figure 2 Adults participating in a stokvel by LSM



Source: ACNielsen. *FutureFact Marketscape Survey 2002.* Johannesburg

On average, stokvel members contribute between two and eight per cent of monthly income to their stokvel, with a higher proportion at lower LSMs. The fact that sixty per cent of stokvel members have a personal bank account indicates that more often stokvels do not substitute, but rather complement formal financial services.

Usage of credit

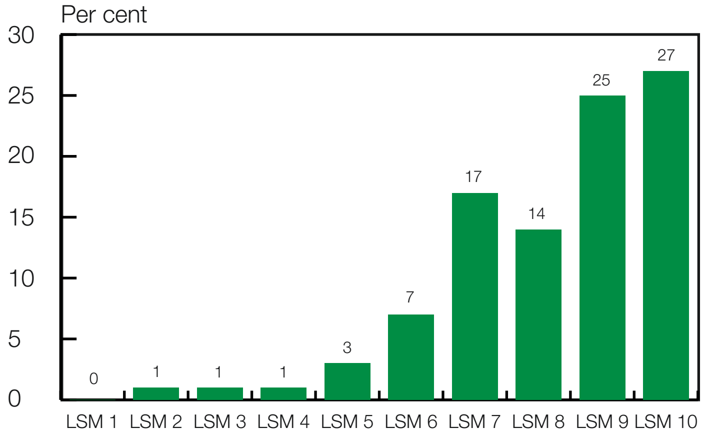
The diversity of credit products provided to individuals makes it a challenge to aggregate overall levels of credit access. However, one proxy for this is the number of credit active individuals recorded by the credit bureaux. The largest consumer credit bureau reports over 16 million credit active individuals, or 55 per cent of the adult population. Of these, some 2,4 million (15 per

8 The remaining seven million people are not economically active.
9 A South African form of informal or indigenous practice for savings and loan services.

cent) have had judgments recorded against them in the last three years.

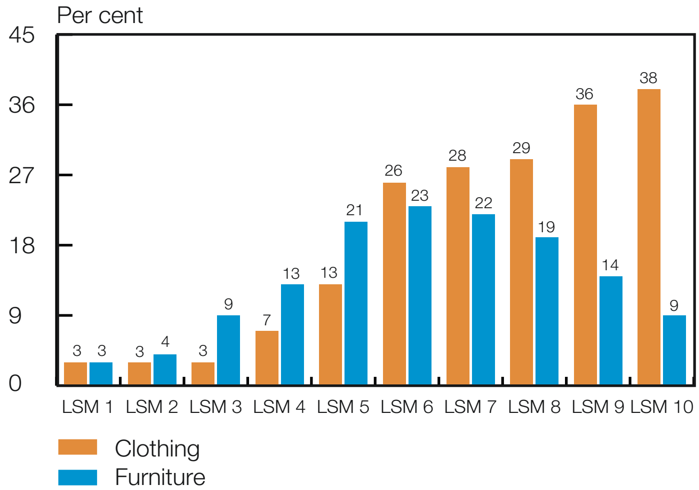
Figures 3 and 4 show the distribution of various credit products across LSMs. Figure 3 demonstrates that home loans (mainly mortgages) have very little penetration outside of the predominantly urban, middle to upper income LSM 7 – 10 (top 20 per cent of the population).

Figure 3   Adults with home loans by LSM



Source: ACNielsen. *FutureFact Marketscape Survey 2002.* Johannesburg

Figure 4   Adults with clothing and furniture accounts by LSM

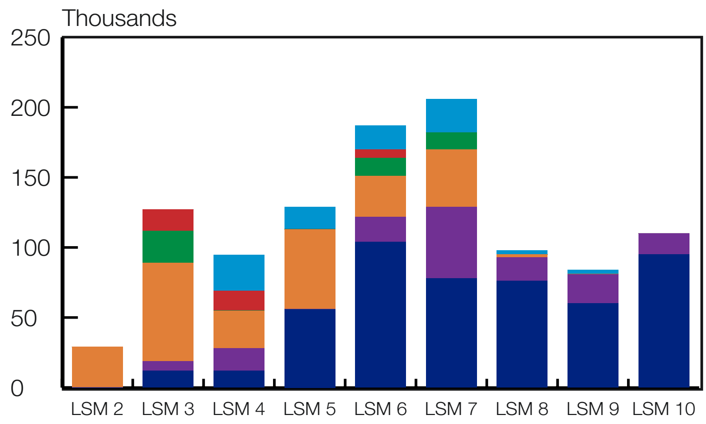


Source: ACNielsen. *FutureFact Marketscape Survey 2002.* Johannesburg

By contrast, in Figure 4 it is evident that retail credit has penetrated much further into LSM 4 – 6 (40 per cent of the population), particularly credit to buy furniture. This is in part because the product financed is itself the collateral for the loan under an installment sale or hire purchase agreement. The lack of adequate collateral is a big stumbling block to the sustainable extension of credit to poorer people who lack marketable assets, hence the importance of peer collateral and other non-financial means of collateralising loans in certain successful micro-enterprise lending schemes.

Finally, Figure 5 shows the sources of loan finance for those who admitted to having a loan – this definition excludes retail credit and tends to favour shorter-term credit. Banks are major sources of loans for upper income clients, with formal and informal micro-lenders playing an important role in the LSM 2 – 6 range.

Figure 5   Sources of loan finance by LSM*



* LSM 1: Individuals within this segment claim to have no access to any type of loan

Source: ACNielsen. *FutureFact Marketscape Survey 2002.* Johannesburg

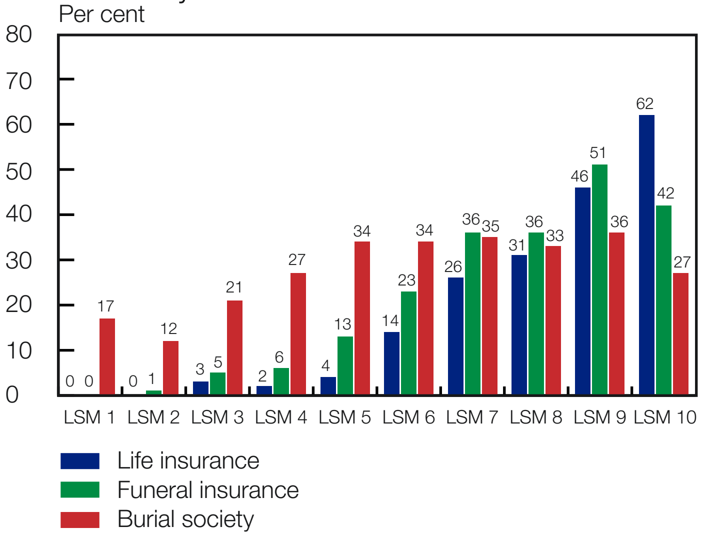
Insurance

Eleven million adults (38 per cent of the adult population) report using at least one of the following insurance-related products which provide different types of

cover against the cash-flow risks to dependents following death:
- whole life insurance;
- funeral insurance; and
- membership of a burial society.

The distribution by LSM is shown in Figure 6, where only burial societies (with 7,4 million members) record substantial penetration below LSM 6.

Figure 6 Adults with life insurance, funeral insurance or burial society membership by LSM



Source: ACNielsen. *FutureFact Marketscape Survey 2002.* Johannesburg

Incidentally, short term insurance (household, car, etc.) is held by little over 10 per cent of adults, the majority of whom are in LSM 8 – 10.

Policy implications

There are a number of policy and regulatory initiatives under way which will have a direct impact on levels of access to financial services in South Africa. One important example is the Nedlac Financial Sector Summit. At this meeting of government, business, labour and community constituencies in August 2002, a wide ranging declaration was signed. Essentially, the parties committed to the principles of promoting greater access and to an ongoing monitoring mechanism. Various issues were highlighted, in particular, access to transaction and savings facilities. Reaching an agreement has also significantly improved relations between government and the financial sector. A task team was formed to monitor the implementation of the proposed strategies.

Ongoing research seeks to ensure that the needs of under-serviced households are better understood since any practical solution has to be demand driven. It is becoming increasingly evident that a continuum of access exists across households, and that to discuss policy in these terms is more constructive than to use the simple dichotomy in the traditional debates of the banked and the 'unbanked'.

Policy makers need to consider carefully the potential and limits of market-driven solutions in the face of these needs, especially since profitability in low end markets is usually a function of scale and certainty. Equally, much vaunted 'informal' solutions such as stokvels or co-operatives may have the advantage of low cost and easy access but carry unique risks to their members. A clear policy framework around the provision of the different types of financial services would create greater certainty, and would aid policy co-ordination across the various affected government departments.

Good policy, however, will not in itself expand access, and careful attention needs to be given to the sequencing of policy initiatives to ensure that the ability to implement exists within regulatory agencies. A clear starting point is the expansion of transaction facilities – basic bank accounts – which allow for day to day safe storage of value and for transmission of funds. This would strengthen the backbone of the financial sector, on which other financial services such as credit and insurance also depend for expansion of access.

Finally, notwithstanding the best efforts of the public and private sectors, access will be affected by macroeconomic conditions, which will create income generating opportunities and the ability to afford more and better financial services. The level of access, however, is not only a passive outcome of the macroeconomy. It is also an input, since increasing access will also undergird and stimulate the forces which lead to faster, more equal growth, such as better savings mobilisation and access to capital. This is why access to financial services matters, and why the current micro-level debates around access may have macro implications going forward.

Box 3 Categorisation and sources of data

For this paper, the focus is on the individual consumer, rather than on business entities which are distinct from the individual owner. This is not to ignore the substantial constraints faced by small, medium and micro enterprises (SMMEs) in accessing financial services, but very little reliable data is presently available.

The major relevant consumer data sets in South Africa result from large scale consumer surveys in which financial questions are posed. This paper draws on data from two recent surveys in particular:
- All Media Product Survey (AMPS) 2001: the largest survey of approximately 30 000 households selected as a random stratified sample, administered by the SA Advertising Research Foundation (SAARF), which is used as the basis for the creation of Living Standard Measures (LSMs) as a market segmentation tool; and
- ACNielsen. *FutureFact Marketscape Survey 2002*: this nationwide representative survey of approximately 3 000 respondents was completed in late 2001/02.

Product categorisation: A distinction is drawn between four basic categories of financial services, which correspond to different consumer needs.

Table 1 Financial product categorisation

Category	Consumer need	Product examples in SA
Transactions	A secure means of storing, accessing and tranferring cash for day to day purposes	Current account Debit card account
Savings	A secure means of accumulating usefully large lump sums over time	Savings account Endowment policy Mutual fund ROSCAs
Credit	Access to liquidity to bridge cash flow shortfalls, particularly for major purchases (e.g. house, car, furniture, education, etc.)	Credit card Overdraft Mortgage Hire purchase Micro-loan
Insurance	Mitigation of impact of defined risks	Life insurance Funeral insurance Burial society Household insurance Medical insurance

Financial development and poverty alleviation: An overview[1]

Paul Holden, Enterprise Research Institute, USA
Vassili Prokopenko, International Monetary Fund, USA

This article[2] highlights some of the issues, and surveys the current state of thinking on the relationship between financial development and poverty alleviation. In addition to indirect macroeconomic links between financial development and poverty reduction, intermediated through economic growth, more direct microeconomic links can be established. These links are derived from the availability of accessible financial instruments, services and institutions for poor households. Until the late 1980s, literature on these macro-microeconomic links had been virtually non-existent. In many developing and socialist countries, the predominant view was founded on the belief that state-owned banks, including special development banks, and subsidised lending could massively reduce poverty. This view was based on the perception that the private sector was not able or willing to supply the necessary financial services to key economic sectors nor did it have any interest in lending to the poor. However, indications are that state-owned financial institutions were not particularly conducive to more general financial market development and did not necessarily provide sustainable financial services to the poor.

In the late 1980s, this approach was countered by a belief that state withdrawal would suffice. As a result, privatisation of state-owned financial institutions became a priority in many countries. However, the expectation that private institutions would rapidly take the place of state-owned banks and improve the provision of financial services to the poor has not always materialised.

The most recent debates about financial services for the poor generally reflect the microfinance movement[3]. It has generated considerable enthusiasm among academics, donors, development practitioners and policy makers. Availability of credit from semi-formal microfinance institutions as well as from informal providers is often seen as an important element that can generate employment in small informal businesses, which in turn has the potential to reduce vulnerability and/or increase the income of the poor.

After a brief survey of the literature on the key theoretical underpinnings regarding the linkages between financial development, economic growth and poverty alleviation, this article attempts to identify the reasons why financial markets remain largely underdeveloped in low and middle income countries. The paper subsequently discusses policy instruments which promote financial development, with a particular focus on financial services for the poor.

Box 1 Definitions of key concepts

Broad money – indicates total deposits of the private sector with the monetary sector. M3 is the broadest money supply indicator and consists of notes, coin and all bank deposits in the hands of the non-bank public.

Extent and the efficiency of financial intermediation – The extent of the financial system describes the proportion of firms and households able to access easily the services provided by financial intermediaries and markets. The efficiency of the financial system refers to how effective these markets and intermediaries are in reducing information and transaction costs for their customers.

Gini coefficient – measures income inequality. It is based on the Lorenz curve, which plots the share of population against the share of income received.

Interest rate spread – is the difference between the average nominal lending rate and the average nominal deposit rate.

Regulation – is a set of rules imposed by authorities on the actions of participants in financial markets.

Supervision – is the manner in which the authorities verify and enforce compliance with the requirements of the regulatory framework.

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1 The views expressed in this article are those of the authors and do not necessarily represent those of the IMF or Enterprise Research Institute.
2 This article is based on: Financial Development and Poverty Alleviation: Issues and Policy Implications for Developing and Transition Countries. *IMF Working Paper 01/160.* Washington: International Monetary Fund, 2001, written by the same authors.
3 See, for example, Ledgerwood, J. 1998. *Microfinance Handbook: An Institutional and Financial Perspective.* Washington, DC: The International Bank for Reconstruction and Development.

The economic growth debate and linkages [4]

Financial development and economic growth

Since the early 1970s, revolutionary work in information economics has shown that inefficiencies can arise within the financial sector when one of the transacting parties has superior information concerning the value of any transaction. In such circumstances, intermediaries play an important role. Akerlof (1970)[5], Stiglitz and Weiss (1981)[6], and Bernanke (1983)[7] developed the foundation of the modern theory of financial intermediation, based on the ability of banks and other financial institutions to resolve the problems arising from the asymmetries in information between the transacting parties.

In the absence of financial intermediation, it is costly for investors to evaluate the quality and performance of firms. Because many firms and entrepreneurs solicit capital, banks and other financial intermediaries can realise economies of scale in obtaining detailed infomation regarding firms' profitability and investment prospects, thereby greatly reducing verification and monitoring costs. With the most promising firms and managers obtaining funds, improved capital allocation fosters growth, other things remaining constant.

The increasingly detailed theoretical analysis of the close relationship between financial development and economic growth has been confirmed by numerous empirical studies (see, for example, Goldsmith, 1969[8] or King and Levine, 1993[9]). Findings confirm that financial development and economic growth not only move closely together but that the former may also predict the latter. King and Levine (1993) also found that the level of financial development in 1960 of 80 different countries was correlated with the subsequent average rate of economic growth over the following 29 years across these countries. This finding was confirmed by Rajan and Zingales (1998)[10]. These authors hypothesised that if finance causes growth, financial development should disproportionately help enterprises or industries that rely more on external finance, as opposed to retained earnings, for investment[11]. If, on the other hand, growth and finance develop together, there should be no differences between sectors of the economy requiring different amounts of financing. Their empirical findings provided positive evidence for the argument that financial development predicts economic growth[12].

Economic growth and poverty alleviation

In theory, economic growth may not be a sufficient condition for poverty alleviation. If income inequality increases, it is possible for a country to enjoy positive economic growth without any benefit to its poorest households – the higher income groups become better off while the incomes of the poor stagnate or decline. Therefore, the relationship between economic growth and income distribution is critical for understanding the ultimate poverty outcomes of growth.

Simon Kuznets was a pioneer in carrying out research on how economic growth affects the distribution of income. In an influential paper (Kuznets, 1955)[13], he argued that the effects of economic growth on income distribution change at different stages of development. Specifically, income inequality widens in the early phases of industrial development. These initial phases involve labour force shifts from an agricultural sector characterised by low but relatively equally distributed income to urban industrial sectors associated with higher but relatively less equally distributed income. Later, inequality becomes stabilised for a while and then narrows in the phases that follow as economies mature.

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4 For the sake of brevity, this section outlines the essential theoretical underpinnings and does not go into a great deal of detail. For a more detailed discussion of the linkages between financial development and economic growth see, for example:
Gertler, M. 1988. Financial Structure and Aggregate Economic Activity: An Overview. *Journal of Money, Credit, and Banking,* Vol. 20, No. 3, Part 2 (August), pp. 559-88, or Levine, R. 1997. Financial Development and Economic Growth: Views and Agenda. *Journal Of Economic Literature,* Vol. 35, pp. 688-726.
For more information on the growth-poverty nexus, see for example: World Bank. 2001. *World Development Report.* Washington, DC: The International Bank for Reconstruction and Development.

5 Akerlof, G. 1970. The Market for Lemons: Quality Uncertainty and the Market Mechanism. *Quarterly Journal of Economics,* Vol. 84 (August), pp. 488-500.

6 Stiglitz, J. E. and A. Weiss. 1981. Credit Rationing in Markets with Imperfect Information. *The American Economic Review,* Vol. 71, No. 3 (June), pp. 393-410.

7 Bernanke, B. 1983. Non-monetary Effects of the Financial Crisis in the Propagation of the Great Depression. *The American Economic Review,* Vol. 73 (June), pp. 257-76

8 Goldsmith, R. 1969. *Financial Structure and Development.* New Haven, CT: Yale University Press.

9 King, R. and R. Levine. 1993. Finance and Growth: Schumpeter Might Be Right. *Quarterly Journal Of Economics*, Vol. 108, No. 3, pp. 717-37.

10 Rajan, R. G. and L. Zingales. 1998. Financial Dependence and Growth. *The American Economic Review*, Vol. 88, No. 3 (June), pp. 559-86.

11 This implies that in countries that are more financially developed an industry such as drugs and pharmaceuticals, which requires a lot of external funding, should develop relatively faster than tobacco, which requires little external finance. Within industries, financial development is more important for young firms that have insufficient retained earnings to finance growth.

12 There are, however, two possible sources of error, which prevent researchers from using evidence that finance predicts economic growth to conclude that it determines economic growth. First, both financial development and economic growth could be driven by a common omitted variable (such as, for example, the propensity of households to save). Second, financial markets may anticipate future economic growth and simply be a leading indicator rather than a casual factor. See Rajan and Zingales (1998).

13 Kuznets, S. 1955. Economic Growth and Income Inequality. *The American Economic Review,* Vol. 45, No. 1 (March), pp. 1-28.

Although many economists accepted this 'Kuznets hypothesis', even though it was based primarily on logic rather than empirical data analysis, more recent work discredits the view that income distribution and stages of growth are related. A series of studies suggests that inequality is largely determined by factors that change slowly within countries but are quite different across countries. Li, et al (1998)[14], for example, found that Gini coefficients over time remained stable within countries whereas they differed across countries.

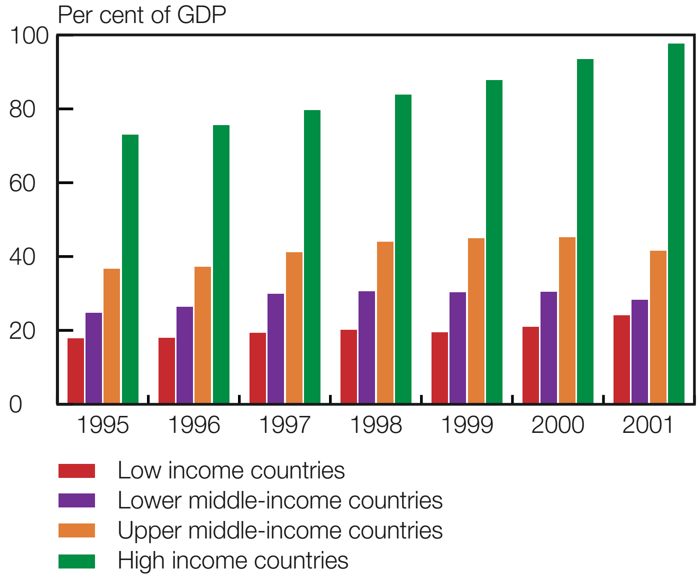
Tanzi (1998)[15] advanced some theoretical arguments highlighting social norms and attitudes as intervening factors in the relationship between economic growth and inequality. Because of the relative stability of these norms over time, they can have a strong influence on income and wealth distribution. Compared to open and more developed societies where macroeconomic and government factors are stronger, traditional and poorer societies are more likely to have unresponsive poverty levels to growth.

An empirical investigation by Dollar and Kraay (2001)[16] revealed that the poor are not excluded from growth induced prosperity. Using a sample of 80 countries over four decades, they examined the relationship between the effect of economic growth on the income of the bottom 20 per cent of the population and found that the income of this group has a unitary elasticity with respect to growth. They also found that the poverty-growth relationship does not change during negative growth episodes or positive growth periods. Furthermore, the relationship between growth and income for the lowest quintile appears to remain unchanged regardless of the levels of development of the countries examined.

Measuring the extent and efficiency of financial intermediation

There are some difficulties in measuring both the extent and the efficiency of financial intermediation. The statistics on conventional indicators of the extent of financial development, such as the ratio of different monetary aggregates to gross domestic product (GDP), can give misleading signals about the condition of the financial sector and its implications for economic activity. If, for example, a relatively high ratio of broad money to GDP reflects a heavily financed public sector by the financial system, with only little bank financing going to the private sector, such a case could hardly be described as promoting economic growth. A more accurate measure of financial development is the ratio of bank credit to the private sector as a per cent of GDP[17]. Figure 1 shows the evolution of this indicator for a sample of 140 countries in the 1995 – 2001 period. The countries are arranged by four income groups. The most striking feature regarding the data is the very high ratio of private sector credit to GDP for the high income group and the low ratios for the three other country groups, especially low income and lower middle-income groups[18]. While these data do not imply that financial development may lead to higher rates of growth, the association of high

Figure 1 Credit to the private sector from deposit money banks



Source: International Monetary Fund, International Financial Statistics database; and World Bank, World Development Indicators database (own calculations)

14 Li, H., L. Squire and H. Zou. 1998. Explaining International and Intertemporal Variations in Income Inequality. *The Economic Journal,* Vol. 108 (January), pp. 26-43.
15 Tanzi, V. 1998. Fundamental Determinants of Inequality and the Role of Government. *IMF Working Paper 98/178*. Washington, DC: International Monetary Fund, December.
16 Dollar, D, and A. Kraay. 2001. Growth Is Good for the Poor. *World Bank Policy Research Working Paper 2587.* Washington, DC: The International Bank for Reconstruction and Development.
17 However, even this indicator may be subject to criticism. For example, if loan classification rules are not adequate, then a high level of credit to the private sector may simply mask lending to poor quality borrowers. Similarly, if the credit assessment capacity of banks is not adequate, a rapid growth in credit to the private sector may result in an increase in non-performing assets and precede a severe crisis rather than economic expansion as, for example, occurred in many South East Asian countries prior to the crisis of 1997. Nevertheless, over an extended period the measure is the best one that is available.
18 Also see Figure 2 which compares South Africa to other emerging economies.

income and substantial financial market development is noteworthy. Box 2 discusses the indicators of financial development for South Africa.

Box 2 South Africa: Selected indicators of financial development

Table 1 compares the evolution of two indicators of financial development of South Africa with the average figures for a group of upper middle-income countries, where GDP per capita in 1999 was between US$3 000 and US$10 000 (with GDP per capita of around US$3 900, South Africa was classified as an upper middle-income country), as well as with the average figures for a group of high income countries, where GDP per capita in 1999 was higher than US$10 000.

The data suggest that South Africa has a more developed financial sector compared with countries that have a similar level of GDP per capita. Credit to the private sector from commercial banks has been steadily increasing in South Africa over the last seven years and reached 80 per cent of GDP in 2001. This was almost twice as high as the average figure for upper middle-income countries (42 per cent of GDP) but still lower than the average for high income countries (98 per cent). The interest rate spread in South Africa is significantly lower than the average for upper middle-income countries but higher than that for high income countries. See Figure 4 on p. 12.

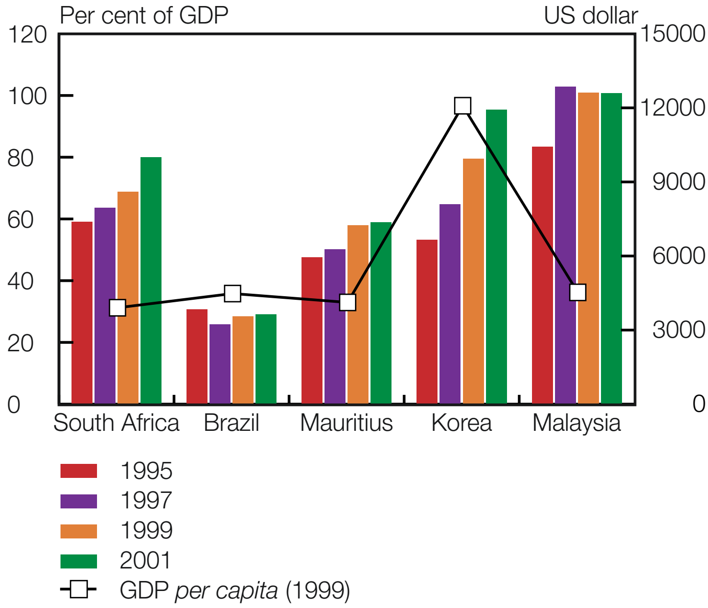
Table 1 South Africa: Selected indicators of financial development

	1995	1996	1997	1998	1999	2000	2001
Credit to private sector from deposit money banks (per cent of GDP)							
South Africa................	59,1	61,5	63,6	68,8	68,9	71,8	80,0
Upper middle-income countries (28 countries)	36,7	37,2	41,2	44,0	45,0	45,2	41,6
High income countries (33 countries)	73,0	75,6	79,6	83,8	87,8	93,5	97,7
Interest rate spread (per cent)							
South Africa................	4,4	4,6	4,6	5,3	5,8	5,3	4,4
Upper middle-income countries (29 countries)	9,5	9,0	9,6	10,0	9,6	8,5	8,6
High income countries (31 countries)	4,1	4,2	4,0	3,8	3,7	3,8	3,9

Sources: International Monetary Fund, International Financial Statistics database; and World Bank, World Development Indicators database (own calculations)

The interest rate spread can theoretically be viewed as the cost of financial intermediation, which mainly reflects the efficiency with which financial intermediaries are able to resolve the problems of informational asymmetries.

Figure 2 Ratio of bank credit to the private sector in selected emerging economies



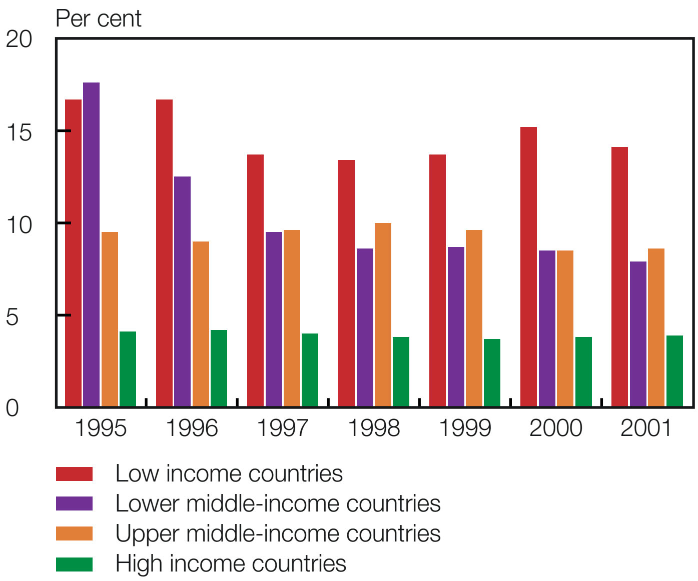
Source: International Monetary Fund, International Financial Statistics database; and World Bank, World Development Indicators database (own calculations)

Figure 3 shows the evolution of the interest rate spread between 1995 and 2001 in 135 countries arranged by the same four income groups. It shows the substantial difference between the cost of financial intermediation in high income and low income countries. While the average spread for high income countries was less than 4 percentage points at the end of 2001, it was above 14 percentage points for the group of low income countries. Although part of the spread may reflect the premium required to compensate for higher risks, which is not indicative of an inefficient financial system since pricing should reflect risks, the substantial interest rate spread primarily reflects inefficiencies in intermediation. Furthermore, the data reflect lending to the most secure borrowers, while lending rates to smaller enterprises are usually much higher.

Reasons for financial underdevelopment

Assessing bilateral relations between financial institutions and their counterparts can identify the reasons for financial underdevelopment. These counterparts can be grouped into four categories, namely owners, depositors, borrowers and regulators.

Figure 3 Interest rate spread



Source: International Monetary Fund, International Financial Statistics database; and World Bank, World Development Indicators database (own calculations)

The ownership structure of financial institutions

State-owned financial institutions have traditionally played an important role in many developing and transition countries. Although research on the proper role of state-owned banks is in progress, issues concerning corruption and corporate governance tend to taint public ownership. However, there are few state-owned financial intermediaries in the world where loss rates are within acceptable prudential norms. Crucial determinants of the efficiency of financial institutions – be they privately or state owned – include the proportion of non-performing loans, the ratio of large to small/medium enterprise clients, transparency and accountability.

State-owned financial institutions are not unique in experiencing agency problems. According to the principal-agent theory, if 'outsiders' (private or public shareholders and depositors) cannot effectively monitor the actions of 'insiders' (managers) who run a particular financial institution, these 'insiders' may not have sufficient incentives to behave prudently and ensure an appropriate risk structure for the assets of their financial institution. As a result, the action of managers may negatively affect the performance of financial institutions. This provides the rationale for regulation and supervision of financial institutions.

Depositors

One of the influential factors of low financial intermediation in many developing and transition countries is the result of the inability of financial institutions to effectively collect private savings. Macroeconomic instability and deficiencies in regulation and supervision of financial institutions are two major factors underlying the low demand for deposit facilities. High, unstable, and unpredictable rates of inflation increase the opportunity cost of holding money. This causes the demand for money to fall as economic agents seek to place their assets in an alternative form (foreign currency, gold, real estate, etc.). Poor regulation and supervision may result in public mistrust of financial institutions and lead to a high ratio of cash holdings to deposits. The supply of savings facilities may also be inadequate. In many developing and transition countries, formal financial institutions do not have the technological capacity to deal with small clients, especially in rural areas.

Borrowers

Unable to effectively mobilise deposits, financial institutions in developing and transition countries provide only little lending to the economy. Low incentives to lend result from the difficulties in resolving information problems. Financial institutions in these countries often have poor credit assessment capacities, which can be attributed to macroeconomic instability, poor borrowers' accounting records, and lack of qualified managers in financial institutions. In addition, the institutions lack effective abilities to monitor the performance of their borrowers. In developed economies, the latter problem is often dealt with by requiring borrowers to pledge their assets as security against default. However, in developing economies weakly defined property rights, especially for moveable property, limit the ability of borrowers to pledge assets as security for loans. In addition, inadequate judicial systems do not allow lenders to pursue remedies for speedy repayment through the courts. As a result banks tend to lend only to the largest borrowers with a well-established reputation or those who are 'connected' to them (banks' owners or employees, or companies that have links with the banks).

Regulation and supervision of financial institutions

In many developing and transition countries, regulation and supervision of financial institutions have several weaknesses. These weaknesses represent a serious impediment to the development of financial markets. The entry requirements, for example, are often inadequate in developing and transition countries. Some countries may have extremely liberal licensing policies which result in a large number of weak institutions being able to obtain banking licenses[19]. This undermines public confidence and hampers financial development. In other countries, overly restrictive requirements for licensing create high barriers to market entry, thus increasing the power of the existing financial institutions and reducing competition which results in a widening of the spread between deposit and lending rates and worsens the problems of adverse selection and moral hazard.

Regarding the regulation of conduct, state involvement in the form of heavy reliance on direct instruments of monetary policy, such as interest rate controls, credit ceilings and directed credits, may have effectively 'repressed' the financial sector in many developing countries. These direct instruments of monetary control generally distort the allocation of financial resources and lead to financial disintermediation and loss of effectiveness (McKinnon, 1973)[20]. In the past two decades, many countries have moved toward a full reliance on indirect instruments of monetary policy (such as open market operations, standing facilities and reserve requirements). However, the direct instruments of monetary policy continue to be actively used in some developing and transition countries.

Where extensive state involvement does not apply, inadequate regulation of conduct may allow financial institutions to engage in connected (or insider) lending, thereby jeopardising their exposure to credit risk. Loans to related companies are often made without guarantee that the financial institution will rigorously apply sanctions later if it discovers financial problems with the affiliated firms.

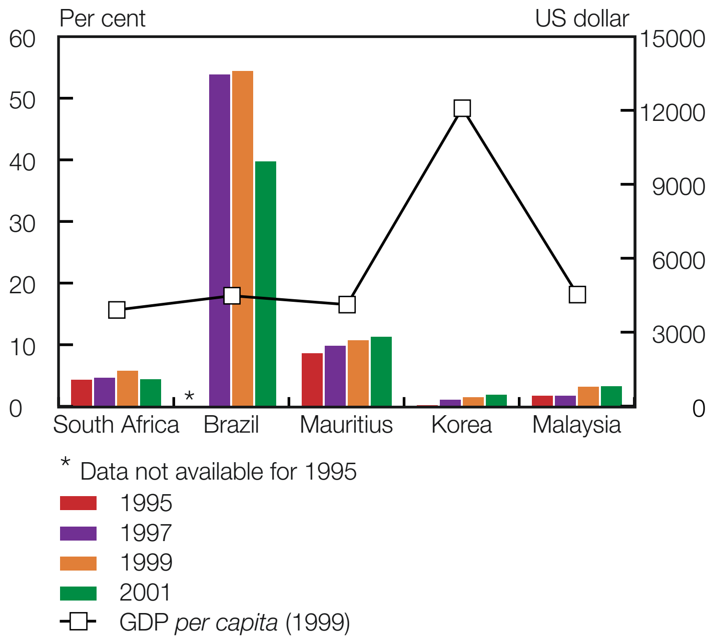
Policy instruments to promote financial development

Having identified the deficiencies in financial intermediation in developing and transition countries, this section looks at some of the policy instruments that might be used to correct these deficiencies. It also discusses how financial services could be expanded and made more readily available to all segments of society, particularly to the poor.

Macroeconomic stability

Macroeconomic stability is a necessary condition for financial markets to flourish. Macroeconomic volatility worsens the problems of informational asymmetries and becomes a source of vulnerability to the financial system. Low and predictable rates of inflation create an enabling environment for financial development, economic growth, and poverty alleviation. Macroeconomic stability is not, however, the sole condition for successful financial development. During the 1980 – 90s, many developing and later transition countries had undergone radical macroeconomic reform which has resulted in much lower inflation rates, yet financial markets remain underdeveloped. Macro-microeconomic policy sequencing is therefore a critical element in this equation.

Figure 4 Interest rate spread in selected emerging economies



Source: International Monetary Fund, International Financial Statistics database; and World Bank, World Development Indicators database (own calculations)

19 This issue was particularly relevant in almost all countries of the former Soviet Union in the early 1990s. Since then, the financial sector has been consolidated in many of these countries, partly as a result of strengthening in regulation. However, some countries are still overburdened by small and weak financial institutions.

20 McKinnon, R. I. 1973. *Money and Capital in Economic Development.* Washington, DC: The Brookings Institution.

The scope for state ownership in financial institutions

Since the late 1980s, the market share of state-owned financial institutions has been falling in the majority of countries throughout the world. Although the fundamental motives behind this tendency to reduce the scope for state ownership of financial institutions were undoubtedly correct, the expected larger volume of lending from privately owned financial institutions, generally has not materialised. In many countries of the former Soviet Union, for example, financial liberalisation has not resulted in increased private credit. One reason for the lack of response was that the state divestiture was not effectively accompanied by the development of the institutional foundations for privately owned financial systems. Therefore, the market share of state-owned financial institutions is not always likely to be effectively replaced by private financial institutions. Given the dismal record of loan losses associated with state-owned financial institutions, particularly development banks, without systemic reform, in most countries the choice appears to lie between large non-performing loans when state banks predominate or privately owned banks that extend credit only to blue-chip customers. For effective intermediation to promote development there is no alternative but to reform the institutional foundations of financial markets.

Role of regulation and supervision of financial institutions

Regulation and supervision of the financial system play a central role in determining both stability and the outreach of services. Regulation and supervision are typically aimed at the protection of depositors from the potentially opportunistic behaviour of the 'insiders' (owners or managers) of banks and other financial intermediaries. Prudential regulation and supervision, processes that are necessary conditions for financial deepening, therefore promote trust in the financial system among potential depositors. Compliance with regulatory and supervisory requirements is likely to create a variety of constraints for the regulated institutions. It is therefore important to ensure that the regulatory regime does not have biases against establishing services in poor and rural areas. In particular, regulations should not prevent banks and other financial institutions from opening facilities in poor areas[21], and should not prohibit mobile banking, in terms of which 'transportable banks' on wheels visit areas that do not have permanent facilities. Analysis of bank regulation within the context of financing development is a topic that is still in its infancy, but which requires much more probing.

Accurate accounting records

Accounting records need to be improved in many developing and transition countries as they provide an indicator of company performance for investors, owners, and partners. Part of the challenge in many developing and transition countries is that standards of auditing and accounting are low, and there are few trained accountants. As a result, virtually all micro enterprises and most small companies in these countries tend to have poor or nonexistent accounting records.

Credit scoring models

Some uncomplicated credit scoring models based on the available information on potential borrowers can be used to evaluate the likelihood of repayment. There is some evidence – albeit still limited – that these models can work effectively in developing and transition countries. As an example, Chaves and Sanchez (1999)[22] found indications of the ability of a credit scoring model to predict repayment rates in Mexico. Using household survey data, a statistical model was developed which derived weights for over 40 variables that were found to be important in predicting the likelihood that loans would be repaid.

Credit information bureaux

As regards larger companies with adequate accounting records, the establishment of credit information bureaux could help with the development of efficient financial markets. The credit information bureau – which can be public or private – represents a centralised database that includes financial information on enterprises, for example, audited balance sheets, current profit-and-loss statements, business plans, and other borrower data such as court records, utility payments and employment profile. Recent studies confirm that the establishment of credit information bureaux is beneficial

21 Mexico provides an example of such constraints imposed on financial institutions. There is a rule governing the size and weight of the safe that Mexican banks must maintain in every branch. While this rule may seem arcane and trivial, the expense that is required to install such an edifice is a significant disincentive to banks to open branches in poorer areas.

22 Chaves, R. and S. M. Sanchez. 1999. Poverty, Entrepreneurs, and Financial Markets in the Rural Areas of Mexico, in A. Valdés and R. Lopez, *Rural Poverty in Latin America.* Washington, DC: The International Bank for Reconstruction and Development.

for the efficient development of financial intermediation (Galindo and Miller, 2001)[23].

An effective system of property rights

An effective system of property rights can reduce adverse selection and moral hazard problems, allowing the development of financial markets[24]. Such a system requires a stable mechanism of contracting institutions such as registries to record ownership and security interests, a court system that can adjudicate contracts, and a system for reliably enforcing court decisions. The presence of these institutions and instruments allows for clearly identifiable ownership, the ability to pledge effectively assets as security for loans, and the ability to repossess security in the event of a default. In most developing and transition countries, rights for both fixed property (real estate) and moveable property (such as machinery, inventory and accounts receivable – also known as chattels) are very poorly protected. As a result, either they are worthless as collateral, or securing them is so expensive and risky that their usefulness is virtually nonexistent to many borrowers. De Soto (2000)[25] points out that there is enormous untapped wealth locked up in the properties of the poor, which goes to waste because of ineffective property rights.

Titling and registering the property of the poor may therefore result in very large wealth effects and substantial financial market development. This claim is strengthened by a number of case studies discussing the experience with formal property registration. Holden (2000)[26], for example, discusses the case of Peru, where secure registered titles for the dwellings of the poor in the outskirts of Lima, the capital, have been provided using revolutionary low cost titling and registration techniques. While the initial value of slum dwelling was low, it still represented an important asset owned by poor families. When a house was titled and registered its value doubled, providing a huge relative increase in net worth. Another example, discussed by Byamugisha (1999)[27], is an ongoing reform programme in Thailand, which had begun in 1960 and led to a large portion of private property holdings being titled and registered which resulted in higher rates of economic growth.

Role of specialised financial institutions

Comparing the financial systems in developing or transition countries with those in developed countries, it becomes apparent that a broad array of the specialised financial institutions does not exist in the former. In developed countries, lending of non-bank financial intermediaries to the private sector often amounts to over 50 per cent of GDP. In most developing and transition countries, however, this ratio is generally the equivalent of less than one per cent of GDP. However, specialised financial institutions may significantly contribute to financial development, economic growth, and poverty alleviation. By knowing the industry that it is financing, the specialised financial institution can better assess financial and investment plans. In addition, in the event of a bankruptcy, such an institution is in a better position to dispose of the assets of the bankrupt business. Another important advantage of some of these institutions, especially leasing companies, lies in their limited reliance on clients' credit history, assets or capital base, or accounting records. This helps the majority of small and medium-size enterprises that do not have historical financial statements.

Semi-formal and informal microfinance institutions (MFIs) can be important providers of financial services to the poor as they enjoy better local knowledge and are better acquainted with the environment. They circumvent the distance problem and provide easier access to financial services for the rural poor. Furthermore, MFIs complement the formal financial system by providing financial services to those who are excluded from the formal economy.

Ongoing research

This paper argues that financial development is necessary for economic growth and could thereby create an enabling environment for poverty alleviation. Financial development does not only contribute to economic growth and to the accessibility of formal or informal financial services for poor households, but it is also an important precondition for poverty alleviation.

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23 Galindo, A. and M. Miller. 2001. *Can Credit Registries Reduce Credit Constraints? Empirical Evidence on the Role of Credit Registries in Firm Investment Decisions.* Washington, DC: The Inter-American Development Bank.
24 Property rights represent all the relevant information about any asset for which registered title exists, or for which ownership can be legally established.
25 De Soto, H. 2000. *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else.* New York: Basic Books.
26 Holden, P. 2000. *Credit and Poverty: Institutional Reforms To Make Financial Markets Work.* Washington, DC: The Inter-American Development Bank.
27 Byamugisha, F. F. K. 1999. How Land Registration Affects Financial Development and Economic Growth in Thailand. *World Bank Policy Research Working Paper 2241.* Washington, DC: The International Bank for Reconstruction and Development.

Macroeconomic stability is one of the necessary conditions for efficient financial development and poverty reduction, whereas macroeconomic volatility reduces the demand for money and complicates credit assessment. High and unpredictable inflation also contributes directly to higher poverty rates because the poor have limited ability to hedge and bear a disproportionately large share of the negative effects of inflation. Additional preconditions for financial development are the promotion of sound institutions and instruments of financial policies. Even in situations where macroeconomic stability has been achieved, institutional failure can inhibit the capacity of financial sectors, especially regarding the provision of services to the poor, and hamper economic growth. In order to facilitate the expansion of small and medium-size enterprises, a conducive environment for specialised financial institutions to operate is one of the options for developing and transition economies.

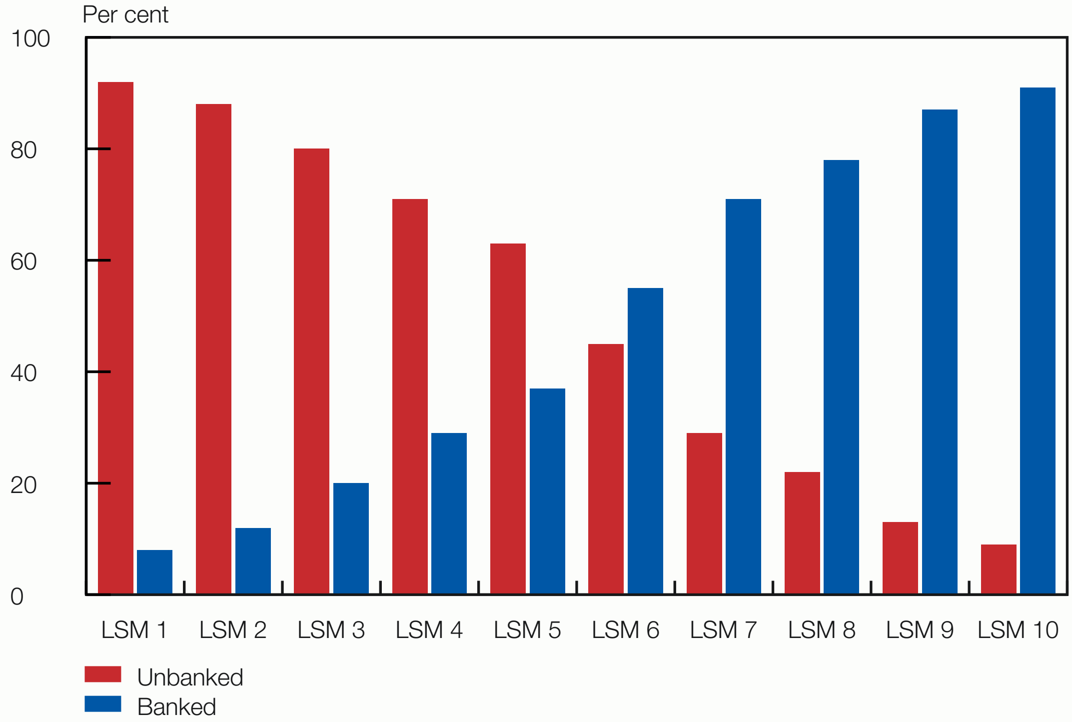
Inevitably issues for further research arise from this discussion. Although the relationship between financial development and poverty alleviation has been studied intensively in recent years, research into this subject is far from over. Perhaps the most important issue for further research is whether microfinance institutions represent a sustainable solution to dealing with financial development and poverty alleviation.

Recent work by Holden, Holden and Sobotka (2003)[28] shows that the better microfinance institutions in some countries in Latin America are performing extremely profitably and have achieved higher rates of return and lower losses than commercial banks. A key finding was that the unsubsidised microcredit institutions outperformed those that were subsidised by, for instance, donors.

28 Holden, P., S.E. Holden and J. Sobotka. 2003. *Microcredit Institutions and Financial Markets.* Washington, DC: Multilateral Investment Fund and The Inter-American Development Bank.

Indicators: The banked and 'unbanked'[1]

Figure 1 Banked and unbanked by Living Standard Measure* (LSM), 2001



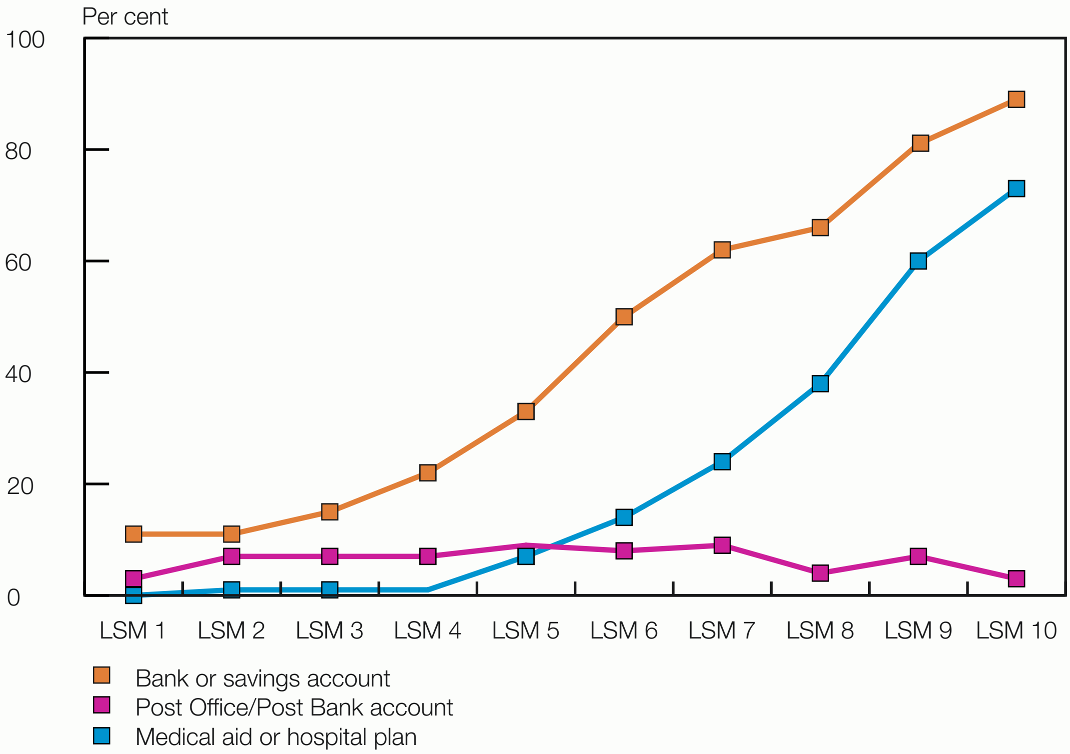
Per cent	LSM 1	LSM 2	LSM 3	LSM 4	LSM 5	LSM 6	LSM 7	LSM 8	LSM 9	LSM 10
Unbanked	92	88	80	71	63	45	29	22	13	9
Banked	8	12	20	29	37	55	71	78	87	91
Total (per cent)	100	100	100	100	100	100	100	100	100	100
Number (millions)	3,04	4,07	4,16	4,01	3,63	3,65	1,74	1,69	1,56	1,47

* LSMs are South Africa's most widely used market segmentation tool, dividing South African households into 10 groups. It is a move away from segmentation based purely on demographics or income. Essentially, the LSM is a wealth measure based on standard of living rather than income mainly associated with living conditions such as consumer durable ownership including cars and major household appliances and degree of urbanisation. It is less useful when applied to financial services, but is the best available simple segmentation tool.

Source: ACNielsen. *FutureFact Marketscape Survey 2002.* Johannesburg

1 Published with permission from FinMark Trust who commissioned the research.

Figure 2 Access to medical aid, Post Office savings and bank savings by LSM, 2001



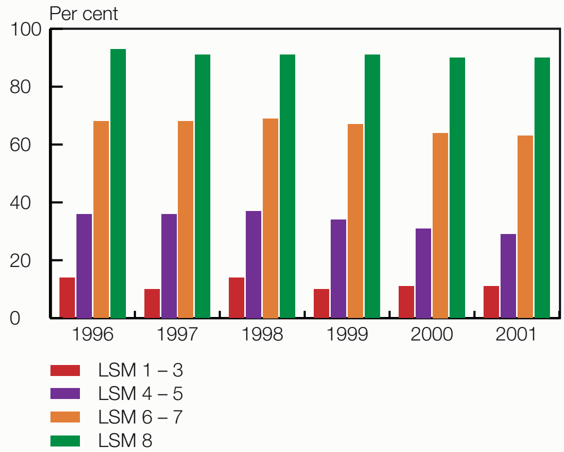
Per cent	LSM 1	LSM 2	LSM 3	LSM 4	LSM 5	LSM 6	LSM 7	LSM 8	LSM 9	LSM 10
Bank	11	11	15	22	33	50	62	66	81	89
Post Office	3	7	7	7	9	8	9	4	7	3
Medical aid	0	1	1	1	7	14	24	38	60	73

Source: ACNielsen. *FutureFact Marketscape Survey 2002.* Johannesburg

Figure 3 Use of any bank account by universal LSM*, 1996 – 2001

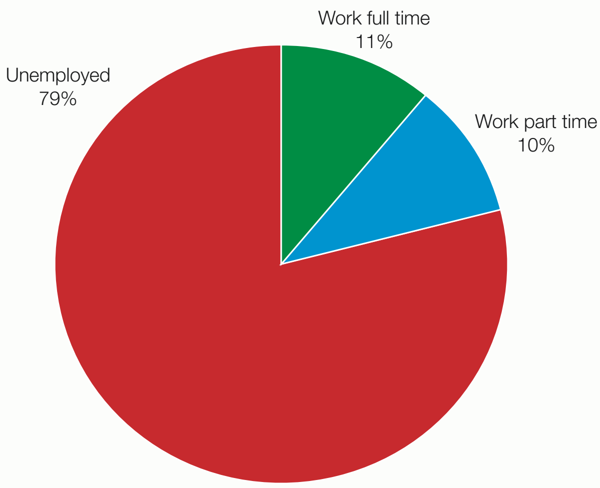
	LSM 1 – 3 per cent	LSM 4 – 5 per cent	LSM 6 – 7 per cent	LSM 8 per cent	Total banked millions
1996......	14	36	68	93	7,846
1997......	10	36	68	91	10,152
1998......	14	37	69	91	10,802
1999......	10	34	67	91	10,273
2000......	11	31	64	90	11,155
2001......	11	29	63	90	11,296

* New LSM 7 is collapsed LSM 7 – 8
New LSM 8 is collapsed LSM 9 – 10



Source: ACNielsen. *FutureFact Marketscape Survey 2002.* Johannesburg

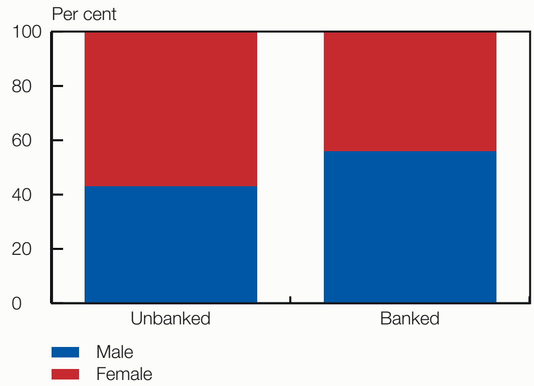
Figure 4 Employment status of the unbanked, 2001



Source: ACNielsen. *FutureFact Marketscape Survey 2002.* Johannesburg

Figure 5 The banked and unbanked by gender, 2001

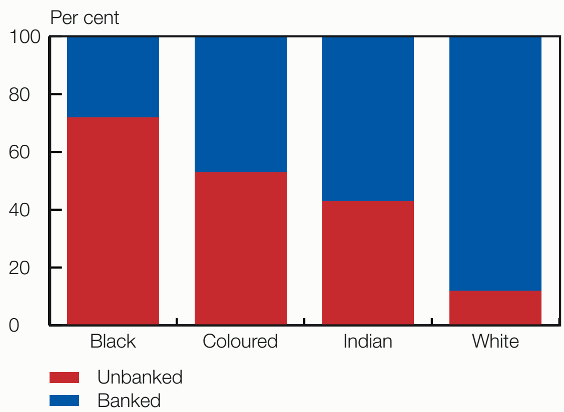
Per cent	Unbanked	Banked
Male	43	57
Female	57	43
Total	**100**	**100**



Source: ACNielsen. *FutureFact Marketscape Survey 2002.* Johannesburg

Figure 6 The banked and unbanked by race, 2001

Per cent	Black	Coloured	Indian	White
Unbanked	72	53	43	12
Banked	28	47	57	88
Total	**100**	**100**	**100**	**100**



Source: ACNielsen. *FutureFact Marketscape Survey 2002.* Johannesburg