What Works for Financial Sector Development?

A review of the evidence

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FSD: ToC - Overview

Policies & Institutions

Reduced risk of financial shocks

Support Functions

Better info., security to lend

Long term Finance

Long term savings=investing

Financial Deepening

Higher private investment

Financial Inclusion

Poor, marginalised able to save/ invest/insure

Outcome
Stable, deep & inclusive financial system

- Financial stability

- Financial depth

- Higher investment

- Pathways out of poverty, avoid poverty traps

Impact
Sustained economic growth, poverty reduction

Results chain: Policies & Institutions

Inputs

Policies & Institutions

- TA: Macro policy
- TA: Banking ,Non-bank financial institutions (NBFI) laws, regulations
- TA: Mobile agent banking laws, regulations
- TA: commercial law development
- TA: bank , NBFI supervision
- TA: national payment system
- TA: deposit insurance ,crisis management

Outputs

- Lower macro risk
- Less crowding out by public sector
- Competitive bank, NBFI markets
- Sound financial institutions builds confidence
- ICT usage enabled within sound regulatory framework
- Ability to cope with bank failures and systemic risks

Outcomes

- Lower risk of financial crisis
- Greater investment in financial sector
- Greater financial depth
- ICT based innovation increases inclusion

Impacts

- Increase, sustained economic growth
- Poverty reduction

Evidence: policies, institutions

Policies, institutions=stability + financial development

Financial shocks=recessions, increased poverty. Strong evidence, 2009, Asian crisis

30% variation in rates of poverty reduction attributable to cross-country variation in financial development

Strong evidence that macro stability, liberal policies and effective prudential regulation lead to financial . But liberalisation not leading to lower spreads.

Strong evidence that creditor rights, contract enforcement and bankruptcy laws lead to financial development

Essential for Systems Approach

Results Chain: Support Functions

Support Functions for Stability, Deepening & Inclusion

Input

Support Functions

- TA: Collateral registries
- TA: Credit bureaus, credit reporting standards
- TA: Retail payment systems
- TA: financial access surveys
- TA: research & product development
- TA: corporate governance, financial reporting standards
- TA: bank, NBFI , micro finance training

Outputs

- Greater security of lending
- Better Information on borrowers
- Better access through inter-operable retail systems
- Better understanding of demand
- Products to meet supply gaps
- Improved supply of skills

Outcomes

Short term:

- Financial depth increased
- Firms able to access external finance are able to invest and grow

Long term:

- Increased productivity
- More efficient financial intermediation
- Greater diversity of financial needs met
- Higher savings as % of GDP

Impacts

- Increased, sustained growth
- Poverty reduction
- Higher proportion of population access to financial instruments and institutions

Evidence: support functions

Support functions=better information + security of lending + efficient infrastructure + skilled workforce

Good evidence that credit bureaus, collateral registries contribute to greater lending.

Good evidence that payments infrastructure, inter-operability, rating systems lead to efficiency

But supply driven. Information on demand can make a difference (low cost accounts, savings) but is woefully inadequate. Many products fail

Many programmes fcous on skills but lack of good evidence on outcomes

Enabler of Systems Approach

Results Chain: Long Term Finance

Input

Long term Finance

- TA: Capital market development; infrastructure, training
- TA, guarantees: stock, bond issuance, collective investment schemes
- TA, guarantees: research, product development, securitization
- TA: private equity, impact investment

Outputs

- Returns on savings increases
- Increase in contracted savings
- SMEs able to raise long term finance
- Impact investors deliver financial & social returns
- More households have insurance, pensions

Outcomes

- Stock markets contribute to growth
- Poor have access to insurance and pensions
- Impact investors develop businesses & industries that matter for the poor

Impacts

- Increased, sustained growth
- Poverty reduction

Evidence: Long Term Finance

Demigurc-Kunt and Levine (1996) – Financial development leads to increase in the assets of the banking system and non-bank financial institutions

Financing for infrastructure shown to have good results and some evidence to support impact investment

But macro evidence of link between stock markets and growth is weak. Micro Evidence shows link to credit and growth but not conclusive.

Evidence for pensions and insurance weak; many studies show reverse causality. Micro insurance is growing rapidly but results not as expected and some products have proved expensive failures.

Impact may be on FSD not growth or poverty. More research needed.

Results Chain: Financial deepening

Input

Financial Deepening

- TA, grants: business support services
- TA: Downscaling commercial bank lending, reducing transaction cost
- TA: Microfinance up-scaling
- TA: credit guarantee schemes
- TA, grants: research, product development, Islamic banking
- TA: cluster, value chain lending

Outputs

- Better investment projects
- SMEs able to access finance
- Micro business able to grow
- Banks more willing to lend to SME
- Greater supply of cash flow based project/transaction finance to SMEs
- Stronger disciplines on borrowers reduces non-performing loans

Outcomes

- Private credit/GDP ration increases
- MSMEs increase contribution to growth
- Increased productive employment
- Savings and insurance provide social protection, incentive to invest

Impacts

- Increased, sustained growth
- Poverty reduction

Evidence: Financial Deepening

- Private credit/GDP = higher investment + consumption smoothing + investment in human capital
- Causality of deepening to growth has been proven robustly. Strong evidence for depth and growth in country. But pathways not well understood.
- Positive links with reducing inequality, hunger, resilience to shocks and poverty but transmission pathways not well researched.
- Link between A2F and SME growth strong but not panacea, works with transformative enterprises only.

Impact of deepening on growth & poverty is robust

Results Chain: Financial Inclusion

Input	Outputs	Outcomes	Impacts
Financial Inclusion • TA: Financial literacy • TA, grants: training in ICT based services • TA, grants: strengthening savings and loan associations, micro finance institutions • TA, grants: innovative ICT based outreach mechanisms • TA, grants: research, product development for the poor	• Poor empowered to make better use of financial services • Greater supply of formal financial services in rural/un-served areas • ICT reduces transaction costs making it profitable to serve poor • Products adapted to needs of the poor (micro insurance)	• Poor able to smooth consumption better • Less likely to fall into poverty traps • health & education indicators improve • Access to finance enables poor to invest	• Increased, sustained growth • Poverty reduction • Higher proportion of population access to financial instruments and institutions

Evidence: Inclusion

Weaker macro evidence in support of inclusion. Linked to depth and this does reduce inequality/ poverty.

BUT still important for poor: to support livelihoods/ diversification, finance health,/education, smooth consumption, promote resilience.

Financial literacy only works at teachable moments, allied to products.

Past focus on mircocredit. But better understanding now that poor need savings, insurance, payments.

Despite financial diaries, dont know much about demand.

Evidence: Microfinance

- Microcredit – No miracle, used for consumption, modest benefits but essential for entrepreneurs
- Limitations of one-size fits all. Small sums, not tailored to need. Works better when vary terms. Gap between MFIs, banks.
- Stronger evidence for micro savings & smoothing consumption.
- Mirco insurance – very little evidence. Little demand.
- ICT – no evaluations done. But reduces costs and increases outreach
- Need for further research