Access to Finance – An Unfinished Agenda

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Financial exclusion is likely to act as a “brake” on development as it retards economic growth and increases poverty and inequality. Lack of access to external finance can discourage new entrepreneurs and prevent incumbent firms from realizing their full growth potential. Without access to financial services, households will not be able to invest in their human capital, smooth consumption, insure against income shocks, and save for retirement. Despite the emphasis access to financial services has received in the policy debate, we still lack proper measures of access and empirical evidence that links broader access to financial services to development outcomes. This dearth of data has also impeded a more thorough analysis of the determinants of cross-country differences in access to finance, thus leaving us with at best tentative guidance for public policy initiatives in this area.

While we have made progress towards better understanding measurement, determinants and impact of access to financial services, a substantial and exciting agenda remains. That’s in a nutshell the result of a recent conference on Access to Finance, organized by the Finance and Private Sector Development in the World Bank’s Development Research Group and co-sponsored by the World Bank Economic Review. This event brought together leading academics and policy makers interested in access to financial services.

While for many years the focus of policy makers and researchers alike has been on efficiency and stability of financial system, more recently, especially with the impetus of the Year of MicroCredit (2005), more emphasis has been given to access to finance as part of the overall development agenda by international agencies, and the development community more generally. Better data is being recognized by the international community as a means to advance financial inclusion, but large challenges exist. There is little systematic information on who is financially served in developing countries, which financial institutions or services are the most effective at supporting broad-based access, what practical and policy barriers there may be to the expansion of access or what is the welfare impact of relaxing these barriers and expanding access. Such data will be the basis for more thorough analysis on the impact of access to finance on development outcomes, the relative importance of savings, credit and insurance services and the role of different financial institutions, such as commercial banks, postal banks and microfinance institutions. Such data will also help us develop policies to expand access to financial services.

The conference on Access to Finance, held on March 15 and 16 in Washington, DC, focused on (i) measuring access and its barriers, (ii) evaluating the impact of access, and (iii) policies to broaden access, including government’s role. While centering on the presentation of academic papers – a subset of which will be published in a special issue of the World Bank Economic Review – it had ample room for lively discussions between academics and practitioners.

From theory to empirics

Many theoretical models link inequality with growth through financial market restrictions that can be overcome through redistribution or other public policy tools. Much less prominent in the theoretical literature, however, are approaches that try to address the financial market imperfections head-on. This is surprising as recent empirical work shows a negative relationship between finance and income inequality, both at the cross-country level, but also across states within the U.S. However, most of the evidence is either at the very aggregate level – using financial depth measures instead of access – or micro studies using financial wealth to proxy for credit constraints. This gap in the literature is partly due to the unavailability of systematic information on measures of access to finance.

Evidence presented at the conference, however, also shed doubt on whether the finance-poverty link can be reduced to an access to credit-entrepreneurship channel, as often posited by microfinance advocates. Analyzing the negative
relationship between branch deregulation across U.S. states and income inequality in more depth shows that most of the effect came through a closing of the wage gap between men and women, combined with an increase in female employment. While certainly only tentative evidence and to be confirmed for developing countries, this suggests that access to credit might not be the most important dimension along which financial development contributes to lower income inequality.

Why can large proportions of the population in many developing countries not access financial services? Barriers to banking, such as minimum deposits or loan sizes, annual account fees and documentation requirements can prevent the large majority of the population in many developing countries from accessing banking services. For example, to open a checking account in a commercial bank Cameroon, the minimum deposit requirement is over 700 dollars, an amount higher than the average GDP per capita of that country, while no minimum amounts are required in South Africa or Swaziland. Annual fees to maintain a checking account exceed 25 percent of GDP per capita in Sierra Leone, while there are no such fees in the Philippines. In Bangladesh, Pakistan, Philippines, to get a small business loan processed requires more than a month, while the wait is only a day in Denmark. The fees for transferring 250 dollars internationally are 50 dollars in the Dominican Republic, but only 30 cents in Belgium. While these indicators are available for 62 countries for 2004/5, future data compilations efforts of the World Bank under the Getting Finance program will expand the sample and update these indicators on a regular basis.

These higher barriers are also reflected in estimates of the proportion of households with a financial account, ranging from over 90% in Western Europe to less than 20% in Sub-Saharan Africa. While reliable, survey-based numbers on the share of households that uses formal financial services are available for fewer than 40 countries, recent data compilations on the number of deposit and loan accounts across commercial and savings banks and other financial institutions allows an extrapolation and estimate of usage numbers for a large number of countries. However, efforts are also under way to conduct consistent household surveys across a large number of countries in the next years.

What explains this large cross-country variation in barriers to access and use of financial services? Initial explorations point to policies that are also important for financial depth, such as contract enforcement and credit registries. The relationship of access barriers with lack of competition and a heavy regulatory hand is quite strong and free and competitive media seems to be important to ensure access. Interestingly, government ownership of banks is associated with lower barriers on the deposit side (as is foreign ownership of banks), but with higher barriers on the loan side.

What about the impact of institutions more broadly, on financial market participation and use of financial services? One of the papers presented at the conference examined the determinants of financial market participation among immigrants in the U.S. and found that – controlling for many other individual characteristics - immigrants from countries with institutions that more effectively protect private property and provide incentives for investment are more likely to have a U.S. bank account and participate more extensively in U.S. financial markets. These effects are long lasting, with an impact for at least 28 years after immigration, and are even present in immigrants who arrive in the U.S. as young children. These results suggest that institutional reform is likely to be a very important tool in the effort to expand access.

Microfinance – new insights and new challenges

Several papers presented at the conference gave new insights into low-income households’ and microentrepreneurs’ need for financial services and challenges for the microfinance movement. Experimental evidence from Mexico confirms that microentrepreneurs are able to pay the high interest rates charged by formal and informal financial intermediaries given very high returns to capital. Very high return at very low levels of capital stock also implies there may be no minimum investment threshold below which returns to capital are so low as to discourage entry into self-employment.

On the other hand, data from Indonesia indicate that there seems to be at least as much need for consumer credit than for productive credit and microfinance customers do not seem to react to the product offering in ways suggested by theory. Many low-income households identified by MFI credit officers as credit-worthy are reluctant to take on debt. These new findings shed doubt on the premise of many microcredit advocates that lack of credit for productive activities is the only barrier for the poor to lift themselves out of poverty. One could even go a step further and interpret this as evidence that what the poor are really missing are efficient savings services, and microcredit might serve only as second-best solution for them.

In contrast to the well-developed literature on micro-credit, research on “micro-insurance” is still very limited. A study on the introduction of rainfall insurance in India finds surprisingly little take-up of this product, however. The study finds that insurance takeup increases in the correlation between insurance payouts and the risk to be insured, and in wealth, and decreases in credit constraints. The authors also find that inconsistent with theory, risk adverse households are less likely to buy the insurance product, potentially suggesting that many households may be uncertain about the insurance product itself.
An exclusive focus on informal and semi-formal microfinance, however, might be mistaken. Even in countries with banking systems dominated by government-owned banks such as China, informal finance is an imperfect substitute for access to formal banking services. Data from a recent investment climate survey suggest that despite its weaknesses, financing from the formal financial system is associated with faster firm growth, whereas fund raising from alternative channels is not. And evidence from Bosnia and Herzegovina suggests that while the decision to become an entrepreneur is not related to financing from banks, the ability to survive is significantly increased by an existing relationship with a bank.

Outreach – the role of governments

What - beyond institution strengthening – can governments do to deepen and broaden financial systems? Fostering competition seems a promising way towards more outreach as evidence from both the U.S. and Italy shows. As discussed earlier, branch deregulation in the U.S. helped reduce income inequality by making labor markets more competitive and thus reducing the wage gap between men and women. Evidence from the Italian deregulation episode shows that the consequent increase in competition led to better access to credit both by households and enterprises and lower cost of borrowing, with positive repercussions for economic development.

While government ownership of financial institutions and direct intervention in credit markets has had mostly negative consequences for the depth and outreach of financial markets, some governments have started to use private-public partnerships to help overcome coordination failures, first-mover disincentives and obstacles to risk sharing and distribution. Several examples from Latin America show the potential for such interventions, although the jury is certainly still out as to whether the right governance structures are in place and whether the government will really pull out once it is no longer needed. And even if such schemes are successful, they certainly do not take away from the need for long-term institution building.

The conference did not only discuss existing research, but the conversations and discussion also pointed to future areas deserving more attention and analysis, such as the increasing use of technologies such as the mobile phone in banking, which will likely require more analytical work and research on the interaction between technology and regulation. More and better impact evaluations of microfinance innovations and policies are necessary. And finally, and returning to the theme we started out with – we need better data who has access to and uses which financial services and what are the barriers that prevents non-users from access.