

Overview and Summary

FINANCIAL MARKETS AND INSTITUTIONS EXIST TO MITIGATE THE effects of information asymmetries and transaction costs that prevent the direct pooling and investment of society's savings. Financial institutions help mobilize savings and provide payments services that facilitate the exchange of goods and services. In addition, they produce and process information about investors and investment projects to enable efficient allocation of funds; to monitor investments and exert corporate governance after those funds are allocated; and to help diversify, transform, and manage risk. When they work well, financial institutions and markets provide opportunities for all market participants to take advantage of the best investments by channeling funds to their most productive uses, hence boosting growth, improving income distribution, and reducing poverty. When they do not work well, opportunities for growth are missed, inequalities persist, and in the extreme cases, costly crises follow.

Much attention has focused on the depth and efficiency of financial systems—and for good reason: well-functioning financial systems are by definition efficient, allocating funds to their most productive uses. Well-functioning financial systems serve other vital purposes as well, including offering savings, payments, and risk-management products to as large a set of participants as possible, and seeking out and financing good growth opportunities wherever they may be. Without inclusive financial systems, poor individuals and small enterprises need to rely on their personal wealth or internal resources to invest in their education, become entrepreneurs, or take advantage of promising growth opportunities. Modern development theories increasingly emphasize the key role of

Finance is an essential part of the development process—

—and a well-functioning system needs broad access, as well as depth

Thus, access to finance helps to equalize opportunities and reduce inequalities—

access to finance: lack of finance is often the critical element underlying persistent income inequality, as well as slower growth.

Earlier theories of development postulated that a rise in short-term inequality was an inevitable consequence of the early stages of development. However, it is increasingly recognized that inequality can adversely affect growth prospects—which implies that wealth redistribution can spur development. Despite the emphasis that financial market imperfections now receive in theory, development economists have tended to advocate the adoption of redistributive public policies to improve wealth distribution and to foster growth. However, since financial market imperfections that limit access to finance play an important role in perpetuating inequalities, financial sector reforms that promote broader access to financial services need to be at the core of the development agenda. Indeed, if financial market frictions are not addressed, redistribution may have to be endlessly repeated, which could result in damaging disincentives to work and save. In contrast, building inclusive financial systems focuses on equalizing opportunities. Hence, addressing financial market imperfections that expand individual opportunities creates positive, not negative, incentive effects. While theory highlights the risk that selectively increased access could worsen inequality, both cross-country data and evidence from specific policy experiments suggest that more-developed financial systems are associated with lower inequality. Hence, though still far from conclusive, the bulk of the evidence suggests that developing the financial sector and improving access to finance are likely not only to accelerate economic growth, but also to reduce income inequality and poverty.

—but the access dimension of financial development has often been overlooked

Access to financial services—financial inclusion—implies an absence of obstacles to the use of these services, whether the obstacles are price or nonprice barriers to finance. It is important to distinguish between access to—the possibility to use—and actual use of financial services. Exclusion can be voluntary, where a person or business has access to services but no need to use them, or involuntary, where price barriers or discrimination, for example, bar access. Failure to make this distinction can complicate efforts to define and measure access. Financial market imperfections, such as information asymmetries and transaction costs, are likely to be especially binding on the talented poor and on micro- and small enterprises that lack collateral, credit histories, and connections. Without inclusive financial systems, these individuals and enterprises with promising opportunities are limited to their own savings and

earnings. This access dimension of financial development has often been overlooked, mostly because of serious data gaps on who has access to which financial services and a lack of systematic information on the barriers to broader access.

This report is a broad-ranging review of research work, completed or in progress, focusing on access to finance. The report presents indicators to measure financial access, analyzes its determinants, and evaluates the impact of access on growth, equity, and poverty reduction, drawing on research that uses data both at the firm and household level. The report also discusses the role of government in advancing financial inclusion, and these policy recommendations are stressed throughout the report. Although much remains to be learned, a significant amount of empirical analysis has been conducted on these issues over the past years. As with any review, taking stock of all this research also allows us to identify the many gaps in our knowledge and helps chart the way for a new generation of research in this area.

The report pays particular attention to the following themes:

- *Measuring access.* How well does the financial system in different countries directly serve poor households and small enterprises? Just how limited is financial access? Who has access to which financial services (such as deposit, credit, payments, insurance)? What are the chief obstacles and policy barriers to broader access?
- *Evaluating the impact of access.* How important is access to finance as a constraint to the growth of firms? What are the channels through which improved access affects firm growth? What is the impact of access to finance on households and microenterprises? What aspects of financial sector development matter for broadening access to different types of financial services? What techniques are most effective in ensuring sustainable provision of credit and other financial services on a small scale?
- *Adopting policies to broaden access.* What is the government's role in building inclusive financial systems? Given that financial systems in many developing countries serve only a small part of the population, expanding access remains an important challenge across the world, leaving much for governments to do. Not all government actions are equally effective, however, and some policies can be counterproductive. The report sets out principles for effective government policy on broadening access, drawing on the available evidence and illustrating with examples.

This report presents access indicators, evaluates impact, and provides policy advice

Outline of this report

THIS OVERVIEW INTRODUCES THE MAIN MESSAGES of the report, pulling together theory, data, and analysis. It then presents the key policy implications of this material and highlights some of the challenges in the implementation of these recommendations. It concludes with directions for future research.

Chapter 1 starts with analyses of the theoretical models that illustrate the crucial role access to finance plays in the development process, particularly its influence on both growth and income distribution. Then the chapter examines various data sets to assess the ability of both firms and households to access financial services, to identify barriers to access, and to provide an empirical foundation to better understand the welfare impacts of broader financial access.

Chapter 2 focuses on the ability of firms, particularly small firms, to access financial services. It investigates not only the implications for growth and productivity for individual firms, and the economy at large, but also the impact that restrictive financial access can have on the structure of the economy. The chapter also explores which aspects of financial sector development matter for access to external finance—looking at banks, markets, and nonbank finance, and focusing especially on the role of foreign banks.

Attention turns to households and microentrepreneurs in chapter 3, which examines whether an emphasis on financial sector development as a driver of economic growth is consistent with a pro-poor approach to development. After reviewing the theory, empirical evidence at both the micro and macro levels is presented. The chapter then analyzes the barriers to access and how they can be overcome, with particular consideration given to the promise and limitations of microfinance.

An analysis of the government's role in facilitating access to financial services is presented in chapter 4. The chapter starts with a discussion of the important role that institution-building must play in improving access in particular and financial development in general. It then turns to measures to boost market capacity, improve competition and efficiency, and regulate against exploitative and imprudent practices. This is followed by a discussion of the impact that governments can have by owning or subsidizing financial service providers; as an example, the case of government-backed credit guarantee schemes is looked at in some depth. Before concluding, the chapter considers key issues in the political economy of access.

The first step to improving access is measuring it—

—but the paucity of data presents methodological challenges

While data on the financial sector are often considered to be readily available, systematic indicators of access to different financial services are not. Indeed, access is not easy to measure, and empirical evidence linking access to development outcomes has been quite limited because of lack of data. Existing evidence on the causal relations between financial development, growth, and poverty is consistent with theory. However, most of the evidence comes either from highly aggregated indicators that use financial depth measures instead of access or from micro studies that use financial or real wealth to proxy for credit constraints.

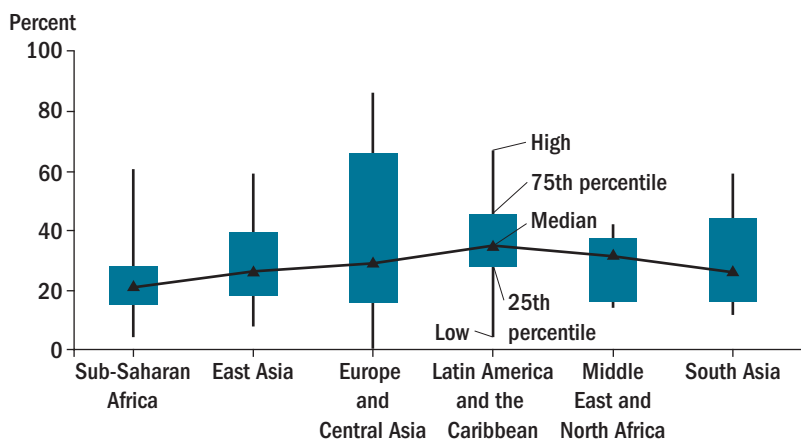
One of the key problems in assessing financial inclusion is that—unlike indicators of financial depth—an analysis of aggregated data sets

has limited value. Simply knowing how many deposit accounts there are, for example, does not reveal much. Some individuals or firms may have multiple accounts, while others have none; moreover, regulatory authorities generally do not collect data on individual account holders. Therefore the best data would be generated by census or survey, which would allow researchers to measure financial access across subgroups. Few such surveys exist for households, however, and the data sets that are available are often not compatible from one country to the next.

In the absence of comprehensive micro data, researchers have sought to create synthetic headline indicators, combining more readily available macro data with the results of existing surveys. These headline indicators indicate that households around the world have limited access to and use of financial services: in most developing countries less than half the population has an account with a financial institution, and in many countries less than one in five households does (figure 1).

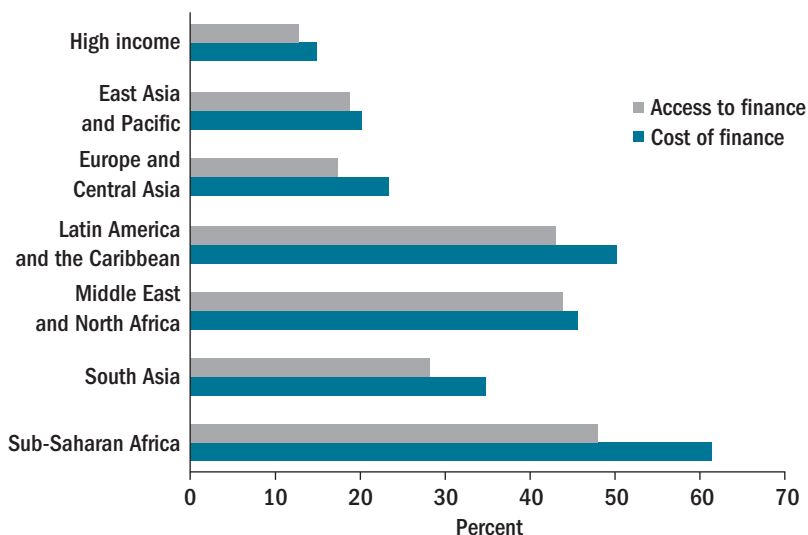
Survey data on the access of firms to finance are more plentiful—although there are concerns about the representativeness of the surveys, particularly with regard to the inclusion of the informal sector (which is larger than the formal sector in many countries). Survey data indicate that less than 20 percent of small firms use external finance, about half the rate of large firms. And in three regions, at least 40 percent of firms report that access to and cost of finance is an obstacle to their growth (figure 2).

Figure 1 Proportion of households with an account in a financial institution



Source: Honohan (2006).

Note: Figure shows the highest and lowest national percentages, as well as the median and quartiles, for the countries in each region.

Figure 2 Percentage of firms reporting finance as a problem

Source: Investment Climate Survey (ICS) responses by enterprises in 76 countries, grouped by region.

Note: Figure shows the percentage of firms reporting access to finance or cost of finance as a severe or major obstacle to firm growth.

Identifying barriers to access: physical access, eligibility, and affordability

Why do large proportions of the populations in many developing countries not use financial services? Identifying the barriers that prevent small firms and poor households in developing countries from using financial services not only helps researchers understand the reasons for financial exclusion but also provides hints as to which policies could be helpful in removing these barriers and broadening access. One major constraint is geography, or physical access. While some financial institutions allow clients to access services over the phone or via the Internet, some require clients to visit a branch or use an automated teller machine (ATM). While an ideal measure would indicate the average distance from household to branch (or ATM), the density of branches per square kilometer, or per capita, provides an initial, albeit crude, indicator. For example, Spain has 96 branches per 100,000 people and 790 branches per 10,000 square kilometers, while Ethiopia has less than 1 branch per 100,000 people and Botswana has 1 branch per 10,000 square kilometers.

Another barrier is the lack of proper documentation. Financial institutions usually require one or more documents for identification purposes, but in many low-income countries, most people—especially those not employed in the formal sector (who are usually poor)—lack such papers.

Finally, many institutions have minimum account-balance requirements or fees that are out of the reach of many potential users. For example, it is not unusual for banks to require a person opening a checking account to make a minimum deposit equivalent to 50 percent of that country's per capita gross domestic product (GDP).

While barriers to access vary significantly across countries, lower barriers tend to be associated with more open and competitive banking systems. Such systems are characterized by private ownership of banks, including foreign ownership; strong legal, information, and physical infrastructures (such as telecommunication and road networks); regulatory and supervisory approaches that rely heavily on market discipline; and substantial transparency and media freedom.

However, access indicators are just that—indicators. While they are linked to policy, they are not policy variables. Thus, creating indicators is only the beginning of the effort. Analytical work collecting and using in-depth household and enterprise information on access to and use of financial services is necessary to understand the impact of financial access and to design better policy interventions. Better data and analysis will help researchers assess which financial services—savings, credit, payments, insurance—are most important in achieving development outcomes for both households and firms, and will inform efforts to narrow down which cross-country indicators to track over time.

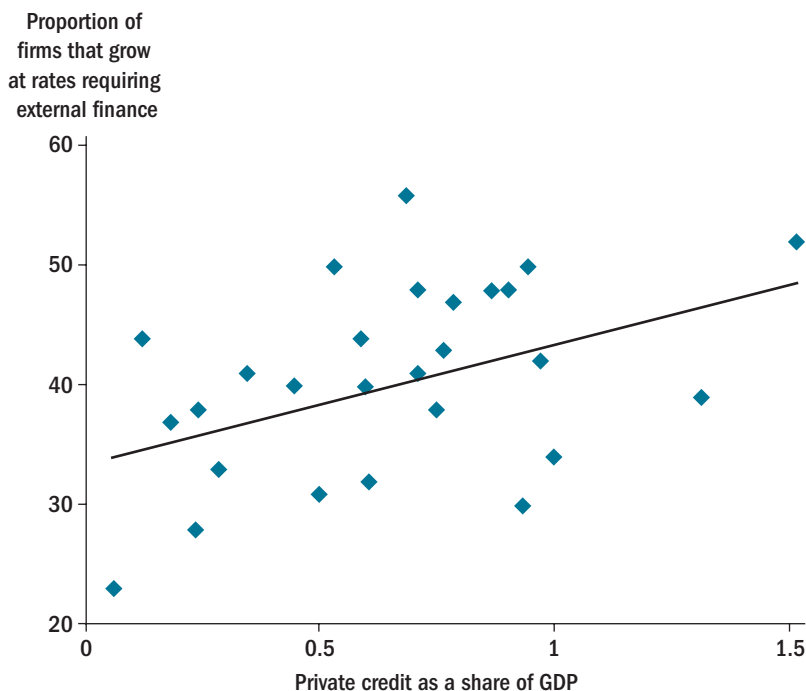
Barriers to access vary significantly across countries

Evaluating the impact of access to finance for firms

One of the important channels through which finance promotes growth is the provision of credit to the most promising firms (figure 3). Many firms, particularly small ones, often complain about lack of access to finance. Recent research using detailed firm-level data and survey information provides direct evidence suggesting that such complaints are valid in that limited access stunts firms' growth. This finding is supported by studies based on census data and individual case studies using detailed loan information.

Access to finance, and the institutional underpinnings associated with better financial access, favorably affects firm performance along a number of different channels. Improvements in the functioning of the formal financial sector can reduce financing constraints for small firms and others who have difficulty in self-financing or in finding private or informal sources of funding. Research indicates that access to finance promotes

Access to finance can promote new-firm entry, growth, innovation, optimum size, and risk reduction—

Figure 3 Finance helps firms grow faster

Source: Demirgüç-Kunt and Maksimovic (1998).

Note: The graph plots the proportion of firms that are able to grow faster than they would if they had no access to external finance against financial development as measured by private credit/GDP.

more start-ups: it is smaller firms that are often the most dynamic and innovative. Countries that strangle this potential with financial barriers not only lose the growth potential of these enterprises but also risk missing opportunities to diversify into new areas of hitherto unrevealed comparative advantage. Financial inclusion also enables incumbent firms to reach a larger equilibrium size by enabling them to exploit growth and investment opportunities. Furthermore, greater financial inclusion allows firms the choice of more efficient asset portfolios as well as more efficient organizational forms, such as incorporation.

—to the benefit of the
economy in general

If stronger financial systems can promote entry of new firms, enterprise growth, innovation, larger equilibrium size, and risk reduction, then it is almost inescapable that stronger financial systems will improve aggregate economic performance. Improved finance does not raise aggregate firm

performance uniformly, however, but rather transforms the structure of the economy by affecting different types of firms in different ways. At any given level of financial development, smaller firms have more difficulty accessing external finance than do larger companies. But with financial development and greater availability of external finance, firms that were formerly excluded are given opportunities. Research shows that small firms benefit the most from financial development—both in terms of being able to enter the marketplace and of seeing their growth constraints relaxed. Hence, inclusive financial sectors also have consequences for the composition of and competition in the enterprise sector.

Firms finance their investments and operations in many different ways, depending on a wide range of factors both internal and external to the individual firm. The availability of external financing depends not only on a firm's own situation, but on the wider policy and institutional environment supporting the enforceability and liquidity of the contracts that are involved in financing firms. And it also depends on the existence and effectiveness of a variety of intermediaries and ancillary financial firms that help bring providers and users of funds together in the market. Bank finance is typically the major source of external finance for firms of all sizes. Modern trends in transactional lending suggest that improvements in information availability (for example, through development of credit registries) and technological advances in analysis of this improved data (for example, through use of automated credit appraisal) are likely to improve access of small and medium enterprises (SMEs) to finance. Provided that the relevant laws are in place, asset-based lending such as factoring, fixed-asset lending, and leasing are other technologies that can release sizable financing flows even for small and nontransparent firms.

However, relationship lending (which relies on personal interaction between borrower and lender and is based on an understanding of the borrower's business and not just on collateral or mechanical credit scoring systems) will remain important in environments with weak financial infrastructures and strong informal economic activity. Because relationship lending is costly for the lender, it requires either high spreads or large volumes to be viable. If the customer's creditworthiness is hard to evaluate, then there may be no alternative to relationship lending. Indeed, limited access to credit in some difficult environments may be attributable to the reluctance of existing intermediaries to do relationship lending on a small scale.

Use of modern transactional lending by banks helps reach more firms

—but relationship lending will remain important for informal economic activity

Foreign banks are likely to increase access for SMEs—

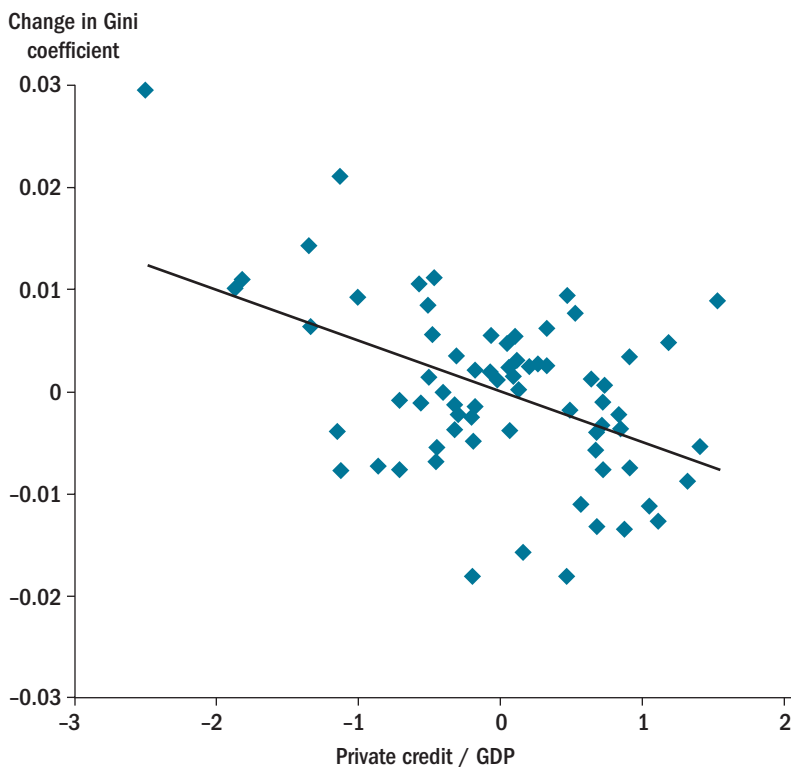
The role of foreign banks in improving access has always been controversial, partly for political reasons. The growing market share of foreign-owned banks in developing and transition economies has resulted from a number of forces, including the privatization of long-established state-owned banks and the sale of distressed banks in the aftermath of banking crises (often after being financially restructured at the expense of the host country government). Foreign owners bring capital, technology, know-how, and independence from the local business and political elites, but debate continues over whether they have improved access. Most foreign banks are relatively large and do not concentrate on SME lending, sticking mostly to the banking needs of large firms and high-net-worth individuals. However, the increased competition for large customers can drive local banks to focus more on providing profitable services to segments they had once neglected. The balance of a large body of evidence suggests that a country that allows foreign banks to operate within its borders is likely, over time, to improve financial access for SMEs, even if the foreign banks confine their lending to large firms and government. In contrast, the performance of state-owned banks in this dimension has tended to be poor.

—and the role of nonbank finance is likely to increase

Nonbank finance remains much less important than bank finance in most developing countries, but it can play an important role in improving the price and availability of longer-term finance to smaller borrowers. Bond finance, for example, can provide a useful alternative to bank finance. The emergence of a large market in external equity requires strong investor rights; where these are present, opening to foreign capital inflows can greatly improve access and lower the cost of capital, with spillover effects for smaller firms. This is true for portfolio equity investments, foreign direct investment (FDI), and private equity, all of which are likely to become increasingly important in the future.

Evaluating impact of access to finance for households

Over the long term, economic growth helps reduce poverty and can be expected to lift the welfare of most households. Evidence suggests not only that finance is pro-growth but that it reduces income inequality (figure 4) and is pro-poor. How important in this process is the direct provision of financial services to poor households and individuals? Existing evidence suggests that indirect, second-round effects through

Figure 4 Finance and income inequality

Source: Beck, Demirgüç-Kunt, and Levine (2007).

Note: The figure is a partial scatterplot of growth of Gini coefficient vs. private credit/GDP, controlling for initial levels of Gini.

more efficient product and labor markets might have a greater impact on the poor than direct access to finance. First, aggregate regressions yield more robust results of a dampening effect of finance on inequality and poverty, while micro studies, which do not consider spillover effects, provide a more tenuous picture. Similarly, calibrated general equilibrium models that take into account labor market effects suggest that the main impact of finance on income inequality comes through inclusion of a larger share of the population in the formal economy and higher wages. Hence, the evidence so far seems to suggest that direct provision of financial services to the poor may not be the most important channel through which finance reduces poverty and income inequality. Therefore, fostering more efficient capital allocation through competitive and open financial markets should remain an important policy goal,

**Financial exclusion extends
beyond the poor in many
countries—**

and it is as relevant for reduction of poverty and inequality as it is for overall economic growth.

In many countries, however, access to financial services is limited to only 20–50 percent of the population, excluding many nonpoor individuals and SMEs. That being the case, improving the quality of the services provided and the efficiency with which they are provided without broadening access is not enough: it would leave large segments of the population and their talents and innovative capacity untapped. The provision of better financial access to these excluded nonpoor micro- and small entrepreneurs can have an especially favorable indirect effect on the poor. Hence, to promote pro-poor growth, it is important to improve access not only to the poor but to all who are currently excluded. That is not to say that improvements in direct access for the poor should be neglected. The benefits here may be more modest in the long run, but they can be immediate.

**—but there are barriers to
increasing access**

There are many reasons for the limited access to financial services, especially in the case of the poor. The poor may not have anybody in their social network who understands the various services that are available to them. Lack of education may make it difficult for them to fill out loan applications, and the small number of transactions they are likely to undertake may make loan officers think it is not worthwhile to help them. As financial institutions are likely to be located in rich neighborhoods, physical distance may also matter—banks simply may not be near the poor. Even if financial service providers are nearby, some poor clients may encounter prejudice—being refused admission to banking offices, for example. The poor face two significant problems in obtaining access to credit services. First, they typically have no collateral and cannot borrow against their future income because they tend not to have steady jobs or income streams that creditors can track. Second, dealing with small transactions is costly for the financial institutions.

**Joint lending and dynamic
incentives may increase
inclusion—**

The new wave of specialized microfinance institutions serving the poor has tried to overcome these problems in innovative ways. Loan officers come from similar backgrounds and go to the poor, instead of waiting for the poor to come to them. Group-lending schemes improve repayment incentives and monitoring through peer pressure, and they also build support networks and educate borrowers. Increasing loan sizes as customers demonstrate their ability to borrow and repay reduces default rates. The effectiveness of these innovations in different settings is still being debated, but over the past few decades, microfinance institutions have managed to reach millions of clients and have achieved impressive

repayment rates. Even though subsidies are often involved, researchers are reconsidering whether it might be possible to make profits while providing financial services to some of the world's poorest. Indeed, mainstream banks have begun to adopt some of the techniques used by the microfinance institutions and to enter some of the same markets. For many, however, the most exciting promise of microfinance is that it could reduce poverty without requiring continuous subsidies.

Has microfinance been able to meet its promise? While many heartening case studies are cited—from contexts as diverse as the slums of Dhaka to villages of Thailand to rural Peru—it is still unclear how big an impact microfinance has had on poverty overall. Methodological difficulties in evaluating impact, such as selection bias, make it difficult to reach any solid conclusion. So far, the evidence from microeconomic studies, taken together, does not unambiguously show a reduction in poverty. Additional research—ideally using more field experiments—is needed to convince the skeptics.

One of the most controversial questions about microfinance is the extent of subsidy required to provide access. Although group lending and other techniques are employed to overcome the obstacles involved in delivering services to the poor, these mechanisms are nevertheless costly, and the high repayment rates have not always translated into profits. Overall, much of the microfinance sector—especially the segment that serves the very poor—still remains heavily dependent on grants and subsidies. Recent research confirms that there is a trade-off between profitability and serving the very poor.

Microfinance has traditionally focused on the provision of credit for very poor entrepreneurs, and enthusiasts often emphasize how microfinance will unleash the productive potential of these borrowers, leading to productivity increases and growth. Yet much of microcredit is not used for investment. Instead, a sizable fraction of it goes to meet important consumption needs. These are not a secondary concern. For poor households, credit is not the only, or in many cases the priority, financial service they need: good savings and payments (domestic as well as international) services and insurance may rank higher. For example, one reason why the poor may not put any savings in financial assets may be the lack of appropriate savings products.

The question, then, has two parts: Should finance for the very poor be subsidized, and if so, is microfinance the best way to provide those subsidies? The answer requires comparing costs and benefits of subsidies

—but the welfare impact of microfinance is not clear—

—and much of the microfinance sector relies on grants and subsidies

The poor need other services in addition to credit—

—and the very poor will require subsidies to access financial services

in the financial sector with those in other areas, such as education and infrastructure. The clear need for the latter set a high threshold if scarce public funds are to be diverted to subsidizing access. Within the financial sector, the case for subsidizing savings and payments services, which can be seen as basic services necessary for participation in a modern market economy, seems stronger than that for credit. In the case of credit, interest rate subsidies in particular do not seem to be the way to go, given their negative incentive effects on repayment, the likelihood that much of the subsidy will in practice be diverted away from the target group, and the chilling effect on unsubsidized service providers just starting to provide small-scale credit. Instead, policies that encourage entry in general are more promising, as are policies that promote the adoption of novel techniques (such as those that take advantage of the already wide and increasing availability of mobile phones). Once in place, such techniques lower the unit cost of service delivery to the poor.

Policies to broaden access

Perhaps more important, improving financial access in a way that benefits the poor to the greatest extent requires a strategy for inclusion that goes well beyond credit for poor households. Since expanding access remains an important challenge even in developed economies, it is not enough to say that the market will provide. Market failures related to information gaps, the need for coordination on collective action, and concentrations of power mean that governments everywhere have an important role to play in building inclusive financial systems. Not all government action is equally effective, however, and some policies can be counterproductive. Direct government interventions to support access require careful evaluation, something that is often missing. Our discussion is selective, setting out principles for effective government policy, drawing on and generalizing lessons from specific examples that illustrate how other issues can be approached.

It is important to have realistic goals

Even the most efficient financial system supported by a strong contractual and information infrastructure faces limitations. Not all would-be borrowers are creditworthy, and there are numerous examples where national welfare has been reduced by overly relaxed credit policies. Access to formal payment and savings services can approach universality as economies develop. However, not everyone will—or should—qualify for credit.

Deep institutional reform ensuring, above all, security of property rights against expropriation by the state is an underlying, albeit often long-term, prerequisite for well-functioning financial systems. Prioritizing some institutional reforms over others, however, would help focus reform efforts and have a positive impact on access in the short to medium term. Recent evidence suggests that information infrastructures matter most in low-income countries, while enforcement of creditor rights is more important in high-income countries. Another finding is that in relatively underdeveloped institutional environments, procedures that enable individual lenders to recover on debt contracts (for example, those related to collateral) are more important in boosting bank lending compared with those procedures mainly concerned with resolving conflicts between multiple claimants (for example, bankruptcy codes). Given that it is potentially easier to build credit registries and reform procedures related to collateral compared with making lasting improvements in the enforcement of creditor rights and bankruptcy codes, these are important findings for prioritizing reform efforts.

Encouraging the development of specific infrastructures (particularly in information and debt recovery) and of financial market activities that can use technology to bring down transaction costs will produce results sooner than long-term institution building. Specific activities include establishing credit registries or issuing individual identification numbers to help establish and track credit histories; reducing costs of registering or repossessing collateral; and introducing specific legislation to underpin modern financial technology—including leasing and factoring, electronic finance, and mobile finance.

Encouraging openness and competition is also an essential part of broadening access, because they spur incumbent institutions to seek profitable ways of providing services to previously excluded segments of the population and increase the speed with which access-improving new technologies are adopted. Foreign banks have an important role to play in expanding access, as discussed above.

In this process, providing the private sector with the right incentives is key; hence good prudential regulations are a necessity. Competition that helps foster access can also result in reckless or improper expansion if not accompanied by the proper regulatory and supervisory framework. As increasingly complex international regulations—such as those envisaged in the advanced versions of the Basel II system—are imposed on banks to help minimize the risk of costly bank failures, it is important

Reforming institutions—

—developing financial infrastructures to take advantage of technological advances—

—encouraging competition—

—and providing the right incentives

to ensure that these arrangements do not inadvertently penalize small borrowers. That can happen if banks are not able to make full allowance for the potential risk-pooling advantages of including SME loans in their overall loan portfolio. Research suggests that while banks making small loans have to set aside larger *provisions* against the higher expected loan losses from small loans—and therefore they need to charge higher rates of interest to cover these provisions—they should need relatively less *capital* to cover the risk that they will lose more than they have anticipated.

A variety of other regulatory measures is needed to support wider access. Sometimes the most effective measure is not the most obvious one. For example, interest ceilings fail to provide adequate consumer protection against abusive lending. Increased transparency and formalization and enforced lender responsibility are more coherent approaches, along with support for the overborrowed (such as assistance in finding a viable workout plan or formalized personal bankruptcy schemes). However, delivering all of this is can be administratively demanding.

The role for direct government intervention is limited

The scope for direct government interventions in improving access is more limited than often believed. A large body of evidence suggests that efforts by government-owned subsidiaries to provide credit have generally not been successful. Direct intervention through taxes and subsidies can be effective in certain circumstances, but experience suggests that they are more likely to have large unintended consequences in finance than in other sectors. For example, with direct and directed lending programs discredited in recent years, partial credit guarantees have been the direct intervention mechanism of choice pushed by SME credit activists. However, these are often poorly structured, embody hidden subsidies, and benefit mainly those who do not need the subsidy. In the absence of thorough economic evaluations of most of these guarantee schemes, their net effect in cost-benefit terms also remains unclear.

In nonlending services, the experience has been mixed. A few government financial institutions have moved away from providing credit and evolved into providers of more complex financial services, entering into public-private partnerships to help overcome coordination failures, first-mover disincentives, and obstacles to risk sharing and distribution that impede outreach to SMEs by banks. Ultimately, these successful initiatives could have been undertaken by private capital, but the state had a useful role in jump-starting these services.

Political economy concerns are key in implementing policies to expand access

A comprehensive approach to financial sector reform aiming at better access must take political realities into account. If the interest of powerful incumbents is threatened by the emergence of new entrants financed

Main messages of this report

FINANCIAL MARKET IMPERFECTIONS THAT LIMIT access to finance are key in most development theories. Lack of access to finance is often the critical mechanism behind both persistent income inequality and slow economic growth. Hence financial sector reforms that promote broader access to financial services should be at the core of the development agenda.

Access is not easy to measure, and empirical evidence linking access to development outcomes has been quite scarce due to lack of data. Initial efforts indicate that financial access is quite limited around the world and that barriers to access are common. Further research to assess the impact of access on outcomes such as growth and poverty reduction will require better micro data, particularly data derived from household and enterprise surveys.

Empirical evidence suggests that improved access to finance is not only pro-growth but also pro-poor, reducing income inequality and poverty. Hence financial development that includes small firms and the poor disproportionately benefits those groups.

Providing better financial access to the nonpoor micro- and small entrepreneurs can have a strongly favorable indirect effect on the poor. Spillover effects of financial development are likely to be significant. Hence, to promote pro-poor growth, it is important

to broaden the focus of attention from finance for the poor to improving access for all who are excluded.

Provision of financial services to the very poor will require subsidies. If subsidies for credit damage the ability and incentives of the microfinance industry and the financial sector more generally to make use of innovative new technologies in providing access for the nonpoor, their effect on the poor could be counterproductive.

However, for poor households, credit is not the only—or in many cases, the principal—financial service they need. Subsidies may be better spent on savings and payment systems because those services are necessary for participation in a modern market economy.

Government policies should focus on building sound financial institutions, encouraging competition (including foreign entry), and establishing sound prudential regulation to provide the private sector with appropriate incentive structures and broaden access. Governments can facilitate the development of an enabling financial infrastructure and encourage adoption of new technologies, but attempts at direct intervention (through subsidies, for example, or ownership of financial institutions) are more likely than not to be counterproductive.

by a system that has improved access and outreach, lobbying by those incumbents can block the needed reforms. Given that challenges of financial inclusion and benefits from broader access go well beyond ensuring financial services for the poor, defining the access agenda more broadly to expand access for all, would include the middle classes and help mobilize greater political support for advancing the agenda around the world.

Directions for future research

While this report reviews and highlights a large body of research, it also identifies many gaps in our knowledge. Much more research is

needed to measure and track access to financial services, to evaluate its impact on development outcomes, and to design and evaluate policy interventions.

More theory work—

New development models link the dynamics of income distribution and aggregate growth in unified models. There are good conceptual reasons for believing that financial market frictions play an important role in the persistence of income inequalities, but there is too little theory that examines how reducing these frictions may affect the opportunities faced by individuals and the evolution of relative income levels. Future theoretical work could usefully study the impact of financial sector policies on growth and income distribution within the context of these models and provide new insights.

**—and more comprehensive
and consistent data**

Lack of systematic information on access is one of the reasons why empirical research on access has been limited. The efforts described above in developing cross-country indicators of access are only first steps in this direction. This work should be continued and expanded, both in terms of country coverage and coverage of institutions and different services available. Building data sets that benchmark countries annually would help focus policymaker attention and allow better tracking and evaluation of reform efforts to broaden access.

Furthermore, while cross-country indicators of access are useful for benchmarking, any assessment of the impact of access on outcomes such as growth and poverty reduction requires data at the household and enterprise level. Few household surveys focus on financial services. Efforts to collect this data systematically around the world are important in improving the understanding of access. Indeed, household surveys are often the only way to get detailed information on who uses which financial services from which types of institutions, including informal ones.

**A better understanding of the
impact of finance**

Emerging evidence suggests that financial development reduces income inequality and poverty, yet researchers are still far from understanding the channels through which this effect operates. The finance-growth channel is better understood: firms' access to finance has been shown to have significant payoffs in many areas, from promoting entrepreneurship and innovation to better asset allocation and firm growth. But how does finance influence income distribution? How important is direct provision of finance for the poor? Which is more important: improving the functioning of the financial system so that it expands access to existing

customers, or broadening access to the underserved (including the non-poor who are often excluded in many developing countries)?

Results of general equilibrium models and evidence at the aggregate level hint that a narrow focus on giving just the poor better direct access is not the best policy. Instead, the poor will benefit most by policies that broaden access in general; moreover, spillover effects of financial development are likely to be important for the poor by improving employment opportunities and wages. However, simply improving competition and the available services for those already served by the financial system is not likely to be enough either. In many countries improving efficiency will require that access be broadened beyond concentrated incumbents, since a large proportion of the nonpoor as well as the poor are currently excluded. Hence the efficiency and access dimensions of finance are likely to be closely linked, but more research is needed to sort out the relative importance of these effects on growth and poverty.

In evaluating impact, randomized field experiments are promising. These experiments operate by varying the treatments of randomly selected subsamples of the surveyed households or microentrepreneurs. For instance, they could be offered different financial products, or different terms and conditions, or different amounts of training in financial literacy. Such random variation allows the researchers to make reliable inferences about how removing barriers and improving access will affect growth and household welfare. While this report discusses some of this research, more experiments need to be conducted in different country contexts, focusing on different dimensions of access. Ultimately, it is this welfare impact that should determine which access indicators should be tracked and how policy should be designed.

Policies to broaden access can take many forms, from improvements in the functioning of mainstream financial products to innovations in microfinance. Lack of careful evaluation of different interventions makes it difficult to assess their impact and draw broader lessons. Careful research in this area would also help improve design of policy interventions to build more inclusive financial systems.

**Randomized field experiments
may provide insights on
welfare impact**

