Financial Sector Development And Poverty Reduction

Dr.Hafiz Ghufran Ali Khan[1], Dr.Hafiz Ghufran Ali Khan[2] and Arif Ahmad[3]

[1] International Islamic University Islamabad

Abstract

Financial sector development is an effective instrument that can bring reduction in poverty. Financial sector can be developed by four different ways, by improving efficiency of the financial sector, by increasing range of financial sector, by improving regulation of the financial sector and by increased accesses of more of the population to the financial services.For estimating effect of financial sector development on poverty we divided financial sector into four sectors, Banking sector, Insurance companies, Stock market and Bond market. Gini= f (Banking sector, Insurance companies, Stock market and Bond market) For banking sector, we used variables, central bank assets to GDP, deposits money banks assets to GDP, bank deposits, concentration, overhead costs and net interest rate. For insurance company we used variable non life insurance, to capture the effect of stock market variable stock market turnover ratio used.For bond market both market capitalization to GDP and public bond market capitalization to GDP are used.This study attempts to make analysis of the relationship between financial sector development and poverty for different countries. Growth depends on financial sector development and poverty depends on growth, here the negative relation of poverty and financial sector development tested.

Index terms— Financial Sector, Poverty Reduction, Growth, Estimating Effects, Negative Relationship.

1 INTRODUCTION

overty is one of the most prominent problems of the whole world. Numerous measures both at macro and micro level have been taken but it is still a burning issue of not only developing countries but also of the developed world. It hurts productive capacity and there by economic growth of the economy. Financial sector development is an effective instrument that can bring reduction in poverty. Theory and evidence shows that Financial Sector Development can impart on poverty directly, to the extent that it widens access to financial services for the poor, and indirectly through its positive impact on growth, which in return help in

2 LITERATURE REVIEW

Functions of financial intermediaries as saving mobilization risk management, acquiring information about investment opportunities, monitor borrowers and facilitating exchange of goods and services help in accumulation of capital and hence increasing rate of technological progress **??**cKinon(1973) and hence enhancing economic growth Levine (1997). There is a strong linkage between financial sector development and economic growth. Financial sector mobilize resources and allocate it to those investment which generate high return. When the financial sector will be efficient and perform these service better the economic performance will be better and growth will be improve so its ultimate result will be less poverty.By facilitating transaction and providing the credit and other financial product to the poor for getting their basic needs help in reduction of poverty DFID,(2004). Banks also provide loans for education so it leads to human capital formation **??**De Gregorio, 1996). More investment, more production and more production first increase the growth level then decrease the poverty level, it is indirect impact of banking sector on poverty reduction.According to **??**ulme. and Mosely

(1996) for sustainable development and poverty reduction we need an efficient financial sector development.More information about the investment opportunity, managed P the risk which leads to high expected rate of return. Getting more information for an individual is very costly. But for financial intermediaries it is less costly and these institutions are also expert in investment , if an individual makes investment it will highly risky and if investment will be made through financial institutions which is less risky and more profitable Gurley and Shaw, (1967); Patrick, (1966); **??**reenwood and Jovanovic, (1990).For an individual it is difficult to monitor performance of an enterprise. Financial institutions monitor performance of different enterprises on behalf of different investor who makes investment on behalf of these financial institutions. By Monitoring and exerting corporate control, financial institutions can promote growth and improve the capital accumulation **??**encivenga and B. Smith (1991) and the ultimate result of it gives poverty reduction. Financial sector can also play role in the form of fast payment services, more branches, improved remittance services in the field of exchange of goods between household and business that reduces transaction cost, thus it can help to promote economic growth.

Financial instability hurt individuals both directly and indirectly. Directly it hurts poor population more as compared to rich, because they are unable to diversify their risk by investing in foreign banks and as they have less power of negotiation Mc Kinnon (1973). Indirectly financial system instability hurt poor by way of growth. Financial instability reduces fund available for investment and therefore it further effect the growth rate. Financial instability also effect real exchange rate because the tradable goods (whose prices are determined by domestic demand and supply) are directly related to credit level (Guillaumont,2005).Janvry A.D.and E. Sadoulet (2000) using data of twelve counties in Latin America from 1970 to 1994, shows that economic growth depends on financial stability and poverty depends on economic growth , and further added that poor is more vulnerable to cyclical nature of growth as compare to rich and the negative impact of recession is more stronger than the positive impact of expansion on poor. Because the negative effect of growth on poor is generally outweigh the positive effect in raising income level **??**Deininger and Squire 1966).Economic growth facilitates the migration of funds to its best possible use. Recent literature Kirkpatrick(2000) developed another indirect link between financial development and poverty through Government intervention. Government intervention in the form of financial policies especially credit market policies which favored the borrowers to obtain credit on subsidized rate of interest, it means to adopt the financial liberalization policy (Kirk **??**atrick 2000).Due to Financial liberalization the economic benefits are trickle down to the lower income group and ultimately reduce the poverty.

Economic growth is necessary for poverty reduction but it must be accompanied by institutional structure and policy environment up to the extent that growth impact the poverty level Lipton and Ravallion, (1955). Economic growth is needed for poverty reduction and it further rely on financial sector development but the linkages of financial sector development and economic growth is not so simple, there is a need of another channel which could be policy intervention and policies which will create an efficient and favorable financial market for capital accumulation and technology innovation Collin Kirkpatrick, (2000).

3   III.

4   METHODOLOGY

For estimating effect of financial sector development on poverty we divided financial sector into four sectors, Banking sector, Insurance companies, Stock market and Bond market. Description of this is given below: Gini= f (Banking sector, Insurance companies, Stock market and Bond market)

For banking sector, we used variables, central bank assets to GDP, deposits money banks assets to GDP, bank deposits, concentration, overhead costs, net interest rate.

For insurance company we used variable non life insurance, to capture the effect of stock m arket variable stock market turn over ratio used. For bond market both market capitalization to GDP and public bond market capitalization to GDP are used. Following model is prepared for estimation: Gini=?

5   DATA DESCRIPTION

Data on Financial sector variable is taken from Thorsten Beck website Data on Gini is taken from WIID website http://www.wiid gini coefficient, .Due to non availability of time series data we take different years data (unbalanced) for different counties in which.

V.

6   EMPIRICAL RESULTS

Using Ordinary Least Square (OLS) method, estimated results are presented in the following Coefficient of concentration is positive which means more concentration more poverty. Concentration of banks reduces the number of choices with consumer and it also reduces the number of rivals in banking sector because banks merge in mega banks. So concentration inversely effect growth and its primary impact on consumer is not good (Prager, R. and T.

7 Hannan (1998))

Coefficient of overhead cost is positive which means that as overhead cost increases poverty also increases. For improving the performance of financial institution it is necessary to fairly allocate the overhead cost such as utilities, computer usage, space and supplies, more overhead cost less will be the performance of the financial institution **??**Rihall, et al., 1994). meeting its deficit which must be repayed along with interst by the consumers in form of taxes. It will adversely effects consumers and leads to more poverty.

8 VI.

9 CONCLUSION

This study attempts to make analysis of the relationship between financial sector development and poverty for different countries. Growth depends on financial sector development and poverty depends on growth, here the negative relation of poverty and financial sector development tested.The banking sector variable (CBA, DMB and BD) proved the negative relation of poverty and financial sector development because all the banking sector variables are negative. Like the banking sector stock market variables also show the negative relation and they are highly significant also. In bond market negative relation between public bond market capitalization to GDP and poverty found. With the improvement of the stated variables of banking, stock and bond market poverty decreased. Apart from these there are other variables like concentration and overhead cost. An empirical result shows the positive relation between concentration and overhead cost with poverty. As concentration decreases the number of rival in banking sector because different banks merge with one another and also decreases the choices with the customers, and the increase of overhead cost is also harmful for financial sector development if it is not fairly managed. All these stated factors about concentration and overhead cost hamper the financial development.

Coefficient of interst rate is negative and highly significant. Higher interst rate leads to decrease poverty because more money is distributed among the depositors. A developed financial system is one that has a secure and efficient payment system in the form of interest (Johann Scharler). Stock market turnover ratio is negative. Private bond market capitalization have negative and highly significant effect while that of government bond capitalization has positive but insignificant effect on poverty. The reason for the negative effect of private bond capitalization on poverty is that private sector raises fund through bond market mainly for the expansion of firm which leads more output more emplyment more incme and less poverty. While on the side government uses bonds for raising fund for [1] [2] [3] [4] [5]

Where as
CBA= Central Bank Assets to GDP
DMB= Deposits Money Bank Assets to GDP
BD= Bank Deposits
Con= Concentration
OC=Overhead Costs
NI= Net Interest rate
NLI= Non Life Insurance pene
SMT = Stock market turnover ratio
PBM =Public bond market capitalization to GDP
GBM =Private bond market capitalization to GDP
IV.

Figure 1:

Dependent variable: Gini Coefficient

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Intercept	40.30504	4.647075	8.673206	0
Central Bank Assets to GDP	-45.02849	14.6766	-3.068047	0.0028
Deposits Money Bank Assets to GDP	-16.00554	9.560759	-1.674087	0.0973
Bank Deposits	-17.06588	9.629179	-1.772309	0.0794
Concentration	61.61029	36.28138	1.698124	0.0926
Overhead Costs	144.9347	48.77275	2.971634	0.0037
Net Interest rate	-15.40079	3.266939	-4.714133	0
Non Life Insurance pene	4.750182	2.566572	1.850789	0.0672
Stock market turnover ratio	-6.916905	2.548054	-2.714584	0.0078
Private bond market capitalization to GDP	-36.46672	6.467128	-5.638781	0
Public bond market capitalization to GDP	6.49047	7.407687	0.87618	0.3831

Table shows that there is negative and highly significant relation between poverty and central bank assets. Coefficient of Deposits Money Bank Assets to GDP is negative.

Figure 2:

127   [©2011 Global Journals Inc. (US)] , *©2011 Global Journals Inc. (US)*

128   [Deininger and Squire ()] , K Deininger , L Squire . *New Dataset Measuring Income Inequality. World Bank*
129   *Economic Review* 1996. 10.

130   [Demirguc et al.] *Band -Based and Market -Based Financial System : Cross -Country Comparison*, Asli Demirguc
131   , - Kunt , Ross Levine .

132   [Gergorio ()] 'Borrowing Constraints, Human Capital Accumulation, and Growth'. De Gergorio . *Journal of*
133   *Economic* 1996.

134   [Scharler] 'Do Bank-Based Financial Systems Reduce Macroeconomic Volatility by Smoothing Interest Rates'.
135   Johan Scharler . *The Importance of Financial Sector Development for Growth and Poverty Reduction Policy*
136   *Working Paper*,

137   [Prager and Hannan ()] 'Do Substantial Horizontal Mergers Generate Significant Price Effects? Evidence from
138   the Banking Industry'. R Prager , T Hannan . *Journal of Industrial Economics* 1998. 46 (4) p. .

139   [Greenwood ()] 'Financial Development , Growth and the Distribution of Income'. Jovanvic Greenwood . *Journal*
140   *of Political Economy* 1990.

141   [Patrick ()] 'Financial Development and Economic Growth in Underdeveloped Countries'. Patrick . *Economic*
142   *Development and Cultural Change*, 1966.

143   [Kirkpatrick ()] *Financial Development, Economic Growth, and Poverty Reduction*, Collin Kirkpatrick . 2000.

144   [Bencivenga ()] 'Financial Intermediation and Endogenous Growth'. Smith Bencivenga . *Review of Economic*
145   *Studies* 1991.

146   [Financial Sector Development And Poverty Reduction] *Financial Sector Development And Poverty Reduction*,

147   [Gurley and Shaw ()] 'Financial Structure and Economic Development'. Gurley , E Shaw . *Economic Develop-*
148   *ment and Cultural Change* 1967.

149   [Hulme ()] Mosley Hulme . *Financial Development and Economic Growth: Views and Agenda*, 1996. 1997. 1.
150   (Journal of Economic Literature)

151   [Rhail and Hrechak ()] 'IMPROVING FINANCIAL INSTITUTION PERFORMANCE THROUGH OVER-
152   HEAD COST MANAGEMENT'. Denis Rhail , Andrew Hrechak . *JOURNAL OF BANK AND COST*
153   *MANAGEMENT ACCOUNTING* 1994.

154   [Mckinnon ()] *Money and Capital in Economic Development*, Mckinnon . 1973. Washington DC: Brookings
155   Institution.

156   [Lipton and Ravallion ()] *Poverty and Policy". Handbook of Development Economics*, M Lipton , M Ravallion .
157   1995. IIIB.

158   [Sylviane et al. ()] 'The Importance of Financial Sector Development for Growth and Poverty Reduction Policy
159   Working Paper'. Guillaumont Sylviane , Kangni Jeanneney , Kpodar . *DFID Policy Division Working Paper*
160   2005. 2004. (Financial Development, Financial Instability and Poverty" 17))