Problems of inequality and poverty in finance

Finance

Abstract

Inequality andpovertyare realities for the majority of developing economies around the world. Intuitively, financial development leading to economic growth should have a positive relationship between the reduction of income inequality (and therefore social inequality) and poverty eradication. Successful regulation of the financial sector leading the economic and political stability will have the effect of increasing access to capital through increased foreign direct investment. In this way FDI can be used to improve access to microfinance which has been identified by the UNDP and developing countries as a primary strategy to poverty eradication as a long-term goal.

Introduction

Literature on poverty alleviation notes that levels of poverty can be decomposed in two distinct ways. The first is through rapid economic growth and the second is though a change in the distribution of income in that economy (Bourguignon, 2004). This literature acknowledges the inherent link between poverty alleviation, economic growth and income redistribution. In terms of statistical representation, Besley and Burgess (2003) prove that in order for alleviation of poverty to occur, developing countries need to effect an annual growth of 3. 8% in the Gross Domestic Product (GDP) in order to half poverty in the next decade which is currently less than half the average growth recorded in recent decades. Therefore although financial development has been shown to produce faster rates of economic growth, literature still remains largely unconvinced of the link between financial development and poverty alleviation (Beck et al., 2004). It goes without saying that income inequality perpetuates social inequality by affording lower-income groups limited access to necessities, commodities, healthandeducationwhich in turn creates a recurring cycle of poverty and inequality in itself. This paper therefore aims to explore the link between financial development and inequality in poverty alleviation with a particular focus on developing countries in Africa. The central hypothesis of this paper asserts that if there is a positive relationship between financial development and the reduction of income inequality, financial development can be used as a means of alleviating poverty in developing countries.

The Impact of Financial Development on Income Inequality

The impact of financial development on the reduction of income inequality is not settled in current research outcomes, with certain models implying that development enhances opportunities for growth and reduces inequality. However, that this reduction is hampered by imperfections in the financial markets with factors such as credit restraints impeding the flow of capital to poorer individuals and communities, therefore enforcing inequality in income and intensifying the wealth disparity in these developing economies (Beck et al., 2004). According to these models, financial development plays the role of reducing these credit restraints and therefore improving the availability of capital for redistribution in lower-income groups and thereby accelerating growth.

Contrary to these models however, Haber et al. (2003) note that in low-income countries, poorer members of society remain in rural areas and therefore rely on access to capital throughfamilyconnections and as a result, financial development will only result in assisting the high-income end of the spectrum. Overall therefore, this may have a negative impact on income inequality. Evidence from developed economies suggest a nonlinear approach to financial development which asserts that at higher levels of economic development, there is increasing wealth available to a larger percentage of the population which may have the effect of offsetting this negative impact (Greenwood & Jovanovic, 1990). The problematic element of this nonlinear model is that reaching higher levels of economic development may take substantial economic growth over a long-period of time, which does little to address immediate concerns of income inequality.

Indicators of financial development include the improvement of information and transactions costs, and the availability and distribution of capital. For developing countries, which often experience a lack of availability of credit, there is a larger reliance on foreign direct investment and private credit institutions to provide capital. In these regions there is a large reliance on micro-financeinstitutions (MFIs) to improve the access to capital for low-income groups. Case studies in developing countries have proven that access to microfinance has a positive impact on poverty alleviation and income inequalities (Meagher, 2002). Practice however has shown that MFI access is in itself problematic as it requires strict regulation of the financial services industry in that country in order to ensure both consumer and investor protection (Omino, 2005). The success of MFIs in providing access to capital relies heavily on a coherent strategy by the government of the country through the central banking institution or primary financial regulation authority.

The Use of Microfinance for Poverty Alleviation

One could argue that the use of microfinance as a means of poverty reduction and income redistribution is a moot point, as it has been popularly acknowledged as a primary long-term strategy for the eradication of poverty. The United Nations Development Programme prioritized microfinance as part of their broader international agenda as a measure of poverty alleviation (UNDP, 1997). As part of this international mandate, the UNDP provided avenues where commercial financial institutions could gain funding from the UNDP as a means of providing microfinance to low-income families with comparatively lower repayment demands and in doing so, catering for the social economic burdens carried by the nationals of the countries involved (UNDP, 2004). This agenda is one that has been adopted by financial regulation authorities in developing countries. The Central Bank of Liberia, for example has adopted a new regulatory framework which provides a unified approach to regulation of the financial sector with a specific focus on MFIs, acknowledge the mandate of the UNDP to make use of these institutions for wealth redistribution and poverty eradication (Central Bank of Liberia, 2009), which was a goal specifically supported by the United Nations Capital Development Fund (UNCDP, 2008). The support for these forms of financing institutions is not specific to Liberia with the UNDP and UNCDP offering similar support to other developing countries around the world, with a specific focus on improving financial development through effective regulation in the sector.

The rationale behind the use of MFIs as a primary means of poverty reduction lies in the access that it gives to lower income groups to encourage small business. This acts as a grassroots approach to wealth redistribution and therefore the use of MFIs has been identified as a primary method of poverty alleviation in developing countries, such as Liberia (Central Bank of Liberia, 2005). Financial development through the use of non-traditional means of providing access to credit for lower-income groups requires unified regulation of the banking sector in developing countries. This necessitates a hierarchical approach to regulation which effectively regulates the relationship between the national financial policy of the country, macroeconomic financial institutions and MFIs. The effect of consistent regulation in this way has the effect of stabilizing the economy of the country, as an unstable economicenvironmentgenerates inflation which has a proven effect on microenterprise that is more severe than established, wealthier companies or corporations (Franks, 2000). Therefore ensuring a stable economic environment is essential to continued wealth redistribution and ultimately poverty alleviation.

Acase studyof the Philippines further showed that the investment in poverty alleviation in this way enhanced the economic and political resources of the average household and as a result had a positive effect on social capital and cooperation through the encouragement of production and industry (Quinones & Siebel, 2000). This in turn had a positive effect on the political stability in this region which further encourages foreign direct investment (FDI) in the economy of the country. The knock-on effect of FDI in developing countries is self-explanatory with a positive result on economic growth and greater access to capital. An unfortunate reality however faces many African nations which represents the converse situation, where many years of poor financial management have led to inherent corruption within the system and in order to make use of the available support offered by the UNDP and UNCDP, these countries require a significant financial overhaul which is low on the priority list for many countries. This is particularly true of developing countries that have suffered the effects of oil wealth, which has had a negative overall effect on economic growth despite an abundance of natural resources which has compounded wealth disparity and poverty (Mahdavy, 1970).

Conclusion

The evidence presented in this paper shows that there are a number of factors required for financial development to positively contribute to a reduction of income inequality (and therefore social inequality) and poverty eradication. The most important factor is effective and unified regulation of the financial sector of the country, which will have the effect of stabilizing the economy and therefore stabilizing interest rates, but also in the stabilization of the political climate in the country. Theoretically, this positions these economies favorably in terms of FDI which will have the effect of increasing the amount of capital available for redistribution. By redistributing wealth at a lower-income level, the nonlinear financial effects of economic growth can be expedited with a realistic alternative to gradual wealth distribution in favour of bottom-up wealth creation. In this way, financial development tackles the problem of wealth disparity and the associated poverty levels from a top-down and bottom-up approach which can reasonably be expected to increase the rate of economic growth, and doing so in a manner that does not rely on singular capital redistribution that may be plagued by imperfections in financial markets. In this way, financial development can be used as a means of alleviating income inequalities and poverty levels in developing countries.

References

Beck, T., Demirguc-Kunt, A. & Levine, R. (2004) Finance, Inequality and Poverty: Cross Country Evidence. NBER Working Paper Series, Working Paper 10979

Besley, T. & Burgess, R. (2003) Halving Global Poverty. Journal of Economic Perspectives, 17, pp. 3-22.

Bourguignon, F. (2004) The Poverty-Growth-Inequality Triangle. World Bank mimeo.

Central Bank of Liberia (2005) Integrating Financial Services into Poverty Reduction Strategies: Institutional Experience of Liberia West-African Regional Workshop, Monrovia: CBL

Central Bank of Liberia (2009) Microfinance Policy and Regulatory & Supervisory Framework for Liberia Monrovia: CBL

Franks, J. (2000) Macroeconomic Stabilization and the Microentrepreneur. Journal of Microfinance, 2, pp. 69-91

Greenwood, J. & Jovanovic, B. (1990) Financial Development, Growth, and the Distribution of Income, Journal of Political Economy, 98, pp. 1076-1107

Haber, S., Razo, A. & Maurer, N. (2003) The Politics of Property Rights: Political Instability, Credible Commitments, and Economic Growth in Mexico. Cambridge University Press.

Mahdavy, H. (1970) ‘ The Patterns and Problems of Economic Development in Rentier States: The Case of Iran’ In Studies in the Economic History of the Middle East, ed. M. A. Cook. London: Oxford University Press

Meagher, P. (2002) Microfinance Regulation in Developing Countries: A Comparative Review of Current Practice Maryland: IRIS Centre

Omino, F. (2005) Regulation and Supervision of Microfinance Institutions in Kenya. Essays on Regulation and Supervision, Central Bank of Kenya, No. 5

Quinones, B., & Seibel, H. (2000) Social capital in microfinance: Case studies in the Philippines. Policy Sciences, 33, pp. 421-433

United Nations Development Programme (1997) Microstart Programme Geneva: UNDP