*Interview with Vassili Prokopenko and Paul Holden*

# Can financial market development reduce poverty?

*In the past, few economists looked closely at the links between financial markets and poverty. But that relationship is now increasingly important in the policy prescriptions of the IMF and other financial institutions. The* IMF Survey *met with Vassili Prokopenko, an Economist in the IMF's Monetary and Exchange Affairs Department, and Paul Holden, Director of the Enterprise Research Institute in Washington, to discuss their Working Paper,* Financial Development and Poverty Alleviation.

*IMF SURVEY:* How has the thinking on the relationship between financial market development and poverty alleviation changed in the last decade or so?

**PROKOPENKO:** In the past, the traditional literature did not pay much attention to financial sector conditions. Now, most agree that financial intermediaries have a role to play. With regard to the linkage between growth and poverty reduction, most now agree that growth is beneficial for the poor. In the past, the thinking had been dominated by the work of Simon Kuznets and others, who argued that growth is more beneficial for the rich than for the poor, at least in the early stages of economic development.

**HOLDEN:** Development paradigms do evolve partly as a result of research on what is important and partly as a result of what is "in fashion." Twenty or so years ago, financial markets were commonly viewed as irrelevant to development and to the poor. There's been a great deal of evolution in that thinking. Financial markets are now seen as essential for promoting growth. Currently, there may be overemphasis on microcredit as an instrument of poverty reduction—in some circles microfinance is seen almost as a panacea for the poor, which is not correct in our view. The interesting debate presently centers on whether microfinance should be trying to help the poor as a direct instrument, or whether it should be promoting entrepreneurship among the poor, which will then lead to less poverty as a trickle-down effect. This critical debate has only just begun, and its outcome will be very important.

*IMF SURVEY:* Microfinance institutions have been the subject of some well-publicized success stories. Why do you urge caution?

**PROKOPENKO:** The quality of a microfinance institution's loan portfolio is often poor because of inadequate management and deficient control of its activities. As a result, many of these institutions never achieve the efficiency needed to cover costs and survive only by getting more subsidies from their donors. And because lending rates of microfinance institutions are usually very high, creditworthy poor are disadvantaged by participating in a pooling financing mechanism in which there are so many low-quality credits. Linkages between the microfinance institutions and commercial banks or other formal financial institutions are often weak. Moreover, there is virtually no path out of the informal sector into the formal sector in the countries where microfinance is widely available.

*IMF SURVEY:* Do you see microfinance as more successful in some regions than others?

**HOLDEN:** Microfinance in Latin America is more developed than elsewhere. In some countries, it is beginning to become viable and sustainable. We have evidence that some commercial institutions are beginning to enter the market successfully without subsidies and are doing very well. Interest rates are high, but it is important to remember that the competition for a microfinance institution is the local money lender, who often charges interest rates of 500–600 percent a year.

**PROKOPENKO:** In some Asian countries like Bangladesh and Indonesia, microfinance institutions are also relatively developed. But in Africa and the countries of the former Soviet Union, they are almost nonexistent.

*IMF SURVEY:* What is the potential for microfinance institutions to provide savings, insurance, and payment services?

**HOLDEN:** These institutions may be potentially important providers of these kinds of services—as well as distributors of remittances from industrial countries to developing countries. These services are extremely important and have a great deal of potential to alleviate poverty. Some fragmentary work done in El Salvador purports to show that having access to these services is at least as important as having access to credit.

*IMF SURVEY:* What are the main policy instruments needed to develop financial sectors in poor countries?

**PROKOPENKO:** Macroeconomic stability is quite important, as is an effective regulatory and supervisory framework. The state's role in the ownership of financial institutions is also important. We argue in the paper that private institutions normally perform better than state-owned institutions. These are probably the main instruments; our paper discusses many more.

**HOLDEN:** Macroeconomic stability is certainly a necessary condition, although it's far from sufficient.

Prokopenko: "With regard to the linkage between growth and poverty reduction, most now agree that growth is beneficial for the poor."

Holden: "Currently, there may be overemphasis on microcredit as an instrument of poverty reduction—in some circles microfinance is seen almost as a panacea for the poor, which is not correct in our view."

Interestingly, one sees wide variations in financial market development among countries that have similar degrees of macroeconomic instability. I would strongly emphasize the importance of the institutional foundations of financial markets, particularly secure property rights—for fixed and movable property. Strong and effective property rights provide the foundation of industrial countries' financial markets, yet in most developing countries these reforms have not occurred.

Prokopenko: "Leasing companies do not rely on the credit history of lessees or on accounting records. So these institutions may develop relatively quickly in poor countries that lack this financial information."

*IMF Survey:* Have there been any recent examples of countries that have made good progress in better defining their property rights?

**Holden:** On the fixed-property side, there was a very interesting World Bank–sponsored reform of titling and registration of poor people's property in Lima, Peru. There have also been very interesting movable-property reforms in Romania; these took place just over a year ago. I have only anecdotal evidence, but it appears to show that in the past year some 85,000 bank loans have been disbursed using movable property as collateral, whereas in the prior period there were essentially none. So the reforms appear to be helping. This is a very interesting case that warrants further analysis because, if it proves successful, it could be a model on which to base other countries' reforms.

Thailand has undertaken a comprehensive rural property reform in which large portions of the country have been titled over the past 20 years. The only econometric study that I have seen on this shows that the reforms have definitely had a strongly positive influence on the growth rate in the longer term.

*IMF Survey:* You highlight significant potential for specialized financial institutions to contribute to financial development and poverty reduction. What specific types of financial services do you see these institutions providing?

**Prokopenko:** Leasing companies do not rely on the credit history of lessees or on accounting records. So these institutions may develop relatively quickly in poor countries that lack this financial information. In some transition countries, such as the Czech Republic or Latvia, leasing companies became a rather important source of finance in the 1990s.

**Holden:** There are great advantages to specialization for two reasons. First, a financial institution that is highly specialized has a much better ability to assess the probability of being repaid because it understands the borrower's business. Therefore, when presented with a loan application, a specialized financial institution is generally better able than a commercial bank to determine the underlying viability of the business applying for financing. Second, in the event of payment default and seizure of assets, a specialized financial institution is much better able to sell the assets, often to its existing customers, and therefore recover a larger proportion of the defaulted amount.

Unfortunately, in most developing countries, the markets are not large enough to allow this type of specialization. Still, leasing is an interesting way around some of the deficiencies in the movable-property laws, because a leasing company often retains ownership of an asset until it's fully paid for and therefore has an easier method of repossessing the asset in the event of nonpayment. I should add parenthetically that there are some countries where trespass laws make it very difficult for leasing companies to operate; consequently, they specialize in leasing assets such as automobiles that remain primarily on public property. In many South American countries, for example, an automobile can be repossessed by the lessor, if necessary, despite trespass laws because the lessor can obtain access to it on the street.

*IMF Survey:* Since the late 1980s, many developing countries have been setting up stock exchanges. Is the development of banking systems and securities markets mutually enhancing? Or is it premature to promote stock markets in poor countries with undeveloped banking systems and perhaps even harmful to their socioeconomic development?

**Prokopenko:** Banking systems and stock exchanges can certainly be mutually enhancing, and the establishment of a stock exchange can benefit overall financial and economic development in a country. But to function effectively, a stock exchange requires a different level of transparency and accounting and a different infrastructure to overcome information problems. It requires some special institutions, such as rating agencies and venture capital firms, that are nonexistent in many developing and some transition countries. Many of the stock exchanges that have been established in developing countries since the 1980s are illiquid; these countries first need to build the necessary infrastructure. It is only then that a stock exchange can enhance overall financial development.

*IMF Survey:* Should priority in the early stages be almost entirely on developing the banking sector?

PROKOPENKO: In countries with poor disclosure and poor accounting, I personally think banks are better suited to financing growth than stock exchanges.

HOLDEN: I would agree. As Vassili said, stock markets require particular types of supporting institutions that are generally well beyond the status quo in most developing countries. Since development, like anything else, is about setting priorities, I would say first develop the banking system, then the supporting financial institutions, and, finally, the stock market. ■

Copies of IMF Working Paper 01/160, *Financial Development and Poverty Alleviation: Issues and Policy Implications for Development and Transition Countries* by Paul Holden and Vassili Prokopenko, are available for $10.00 each from IMF Publications Services. See page 58 for ordering information.

**Members drawing on the IMF "purchase" other members' currencies or SDRs with an equivalent amount of their own currency.**

## Stand-By, EFF, and PRGF arrangements as of January 31

| Member | Date of arrangement | Expiration date | Amount approved | Undrawn balance |
|---|---|---|---|---|
| | | | (million SDRs) | |
| **Stand-By** | | | | |
| Argentina[1] | March 10, 2000 | March 9, 2003 | 10,850.14 | 6,968.78 |
| Brazil[1] | September 14, 2001 | December 13, 2002 | 12,144.40 | 8,468.82 |
| Croatia | March 19, 2001 | May 18, 2002 | 200.00 | 200.00 |
| Gabon | October 23, 2000 | April 22, 2002 | 92.58 | 79.36 |
| Latvia | April 20, 2001 | December 19, 2002 | 33.00 | 33.00 |
| Lithuania | August 30, 2001 | March 29, 2003 | 86.52 | 86.52 |
| Panama | June 30, 2000 | March 29, 2002 | 64.00 | 64.00 |
| Romania | October 31, 2001 | April 29, 2003 | 300.00 | 248.00 |
| Serbia/Montenegro | June 11, 2001 | March 31, 2002 | 200.00 | 50.00 |
| Sri Lanka | April 20, 2001 | June 19, 2002 | 200.00 | 96.65 |
| Turkey[1] | December 22, 1999 | December 21, 2002 | 15,038.40 | 3,299.44 |
| Uruguay | May 31, 2000 | March 31, 2002 | 150.00 | 150.00 |
| **Total** | | | **39,359.04** | **19,744.57** |
| **EFF** | | | | |
| Colombia | December 20, 1999 | December 19, 2002 | 1,957.00 | 1,957.00 |
| Indonesia | February 4, 2000 | December 31, 2003 | 3,638.00 | 2,201.96 |
| Jordan | April 15, 1999 | April 14, 2002 | 127.88 | 60.89 |
| Kazakhstan | December 13, 1999 | December 12, 2002 | 329.10 | 329.10 |
| Ukraine | September 4, 1998 | September 3, 2002 | 1,919.95 | 726.95 |
| **Total** | | | **7,971.93** | **5,275.90** |
| **PRGF** | | | | |
| Armenia | May 23, 2001 | May 22, 2004 | 69.00 | 59.00 |
| Azerbaijan | July 6, 2001 | July 5, 2004 | 80.45 | 72.40 |
| Benin | July 17, 2000 | July 16, 2003 | 27.00 | 12.12 |
| Bolivia | September 18, 1998 | June 7, 2002 | 100.96 | 37.10 |
| Burkina Faso | September 10, 1999 | September 9, 2002 | 39.12 | 11.17 |
| Cambodia | October 22, 1999 | October 21, 2002 | 58.50 | 25.07 |
| Cameroon | December 21, 2000 | December 20, 2003 | 111.42 | 79.58 |
| Chad | January 7, 2000 | January 6, 2003 | 47.60 | 18.40 |
| Djibouti | October 18, 1999 | October 17, 2002 | 19.08 | 10.00 |
| Ethiopia | March 22, 2001 | March 21, 2004 | 86.90 | 52.14 |
| Georgia | January 12, 2001 | January 11, 2004 | 108.00 | 81.00 |
| Ghana | May 3, 1999 | May 2, 2002 | 228.80 | 105.17 |
| Guinea | May 2, 2001 | May 1, 2004 | 64.26 | 51.41 |
| Guinea-Bissau | December 15, 2000 | December 14, 2003 | 14.20 | 9.12 |
| Honduras | March 26, 1999 | December 31, 2002 | 156.75 | 48.45 |
| Kenya | August 4, 2000 | August 3, 2003 | 190.00 | 156.40 |
| Kyrgyz Republic | December 6, 2001 | December 5, 2004 | 73.40 | 61.68 |
| Lao People's Dem. Rep. | April 25, 2001 | April 24, 2004 | 31.70 | 27.17 |
| Lesotho | March 9, 2001 | March 8, 2004 | 24.50 | 17.50 |
| Madagascar | March 1, 2001 | February 29, 2004 | 79.43 | 56.74 |
| Malawi | December 21, 2000 | December 20, 2003 | 45.11 | 38.67 |
| Mali | August 6, 1999 | August 5, 2003 | 51.32 | 19.65 |
| Mauritania | July 21, 1999 | July 20, 2002 | 42.49 | 12.14 |
| Moldova | December 21, 2000 | December 20, 2003 | 110.88 | 92.40 |
| Mongolia | September 28, 2001 | September 27, 2004 | 28.49 | 24.42 |
| Mozambique | June 28, 1999 | June 27, 2002 | 87.20 | 25.20 |
| Nicaragua | March 18, 1998 | March 17, 2002 | 148.96 | 33.64 |
| Niger | December 22, 2000 | December 21, 2003 | 59.20 | 42.28 |
| Pakistan | December 6, 2001 | December 5, 2004 | 1,033.70 | 947.54 |
| Rwanda | June 24, 1998 | April 30, 2002 | 71.40 | 9.52 |
| São Tomé & Príncipe | April 28, 2000 | April 27, 2003 | 6.66 | 4.76 |
| Senegal | April 20, 1998 | April 19, 2002 | 107.01 | 19.54 |
| Sierra Leone | September 26, 2001 | September 25, 2004 | 130.84 | 84.00 |
| Tanzania | April 4, 2000 | April 3, 2003 | 135.00 | 55.00 |
| Vietnam | April 13, 2001 | April 12, 2004 | 290.00 | 207.20 |
| Zambia | March 25, 1999 | March 28, 2003 | 254.45 | 149.63 |
| **Total** | | | **4,213.78** | **2,757.21** |
| **Grand total** | | | **51,544.75** | **27,777.68** |

[1]Includes amounts under Supplemental Reserve Facility.
EFF = Extended Fund Facility.
PRGF = Poverty Reduction and Growth Facility.
Figures may not add to totals owing to rounding.
Data: IMF Treasurer's Department