

FEMISE

MED BRIEF

Forward Thinking for the EuroMediterranean region

September 2019

Med Brief No 25



Simon Neaime is Professor of Economics and Finance, Director of the Institute of Financial Economics, and former Chair

of the Department of Economics at the American University of Beirut.

Dr. Neaime was a Visiting Scholar at York University, in Toronto, Canada in between 2017-2019.

He is associate editor of the *Journal of International Financial Markets, Institutions, and Money* (Elsevier); *Finance Research Letters* (Elsevier); *Research in International Business and Finance* (Elsevier); and *International Journal of Islamic and Middle Eastern Finance and Management*.

His academic articles are published in top field finance and economics journals on emerging economies and MENA economies in particular. Dr Neaime has also published several textbooks on emerging markets.

Keywords : Financial Inclusion, Stability, Poverty, Inequality Reduction, Profitability

FEMISE

CMCI
2, rue Henri Barbusse
13241 Marseille Cedex 01
Téléphone : (33) 04 91 31 51 95
Fax : (33) 04 91 31 50 38
www.femise.org

Financial Inclusion and Stability in the MED Region: Evidence from Poverty and Inequality

in collaboration with :



by Pr. Simon Neaime*

1. Summary

Despite a significant growth in profitability and efficiency, the Middle East (MED) well developed banking system seems to be unable to reach vast segments of the population, especially the underprivileged ones. To this end, the onus of policymakers in the region is to create effective opportunities for financial inclusion, and subsequently poverty and income inequality reduction. Using Panel data spanning the period from 2002-2018, GMM and GLS econometric models, and a sample of six MED countries (Egypt, Tunisia, Algeria, Morocco, Jordan and Lebanon), this policy brief assesses empirically the impact of financial inclusion on income inequality, poverty, and financial stability in the MED region. While the empirical literature on the region is relatively scarce, this brief adds to that literature by bridging a significant existing gap, especially in the aftermath of the recent financial and debt crises and the recent political, social, and military turmoil that have been unfolding in several MED countries.

2. Introduction

Financial inclusion implies that all economic agents are granted access to a range of sophisticated financial services, designed based on their needs and provided at affordable interest cost. Formal financial inclusion begins with having a deposit or transaction account at a bank for the purpose of making and receiving payments, as well as, storing or saving money (Demirguc-Kunt et al, 2017). At a later stage, financial inclusion also involves access to appropriate credit from formal financial institutions, in addition to the use of insurance products that enable people to alleviate risks such as fire, illness, or old age. Furthermore, access to commercial bank accounts through financial inclusion is expected to increase savings among economic agents, leading subsequently to greater consumption and investment spending. This particularly matters for those people who live under the poverty line and mostly in rural areas. In this regard, financial inclusion helps reduce poverty and inequality. On the other hand, there is now a clear recognition that financial stability and inclusion go hand in hand because they represent two sides of the same coin. In several MED countries, the banking sector is by far the dominant financial sector, and it tends to be large relative to the Gross Domestic Product (GDP) when compared with other more developed

countries. Yet, despite their size, access to banking and other financial institutions (credit, bank accounts, number of banks, and accessibility to payment services) is relatively restricted. A recent analysis by the World Bank (Demirguc-Kunt and Klapper, (2012)) found that only 13% of young people in the region had a bank account compared to a world average of 37%, and 17% in Sub-Saharan Africa. And for women in the region, this figure is only 13%. Equally disturbing, bank loans to small and medium enterprises represent only 8% of total bank loans, despite the fact that these institutions are considered the engines of private sector growth and job creation. Moreover, and despite many initiatives introduced to promote financial inclusion in the MED region, fostering financial inclusion remains a critical challenge.

The pursuit of financial inclusion aimed at drawing the unbanked population into the formal financial system now represents a recent preoccupation for policymakers in the region (Pearce, 2011). There is a realization that lack of access to finance adversely affects economic growth and income inequality and poverty alleviation as the impoverished find it difficult to accumulate savings, build assets to protect against risks, as well as invest in income-generating projects. In some MED countries, bank branch expansion and the spread of microfinance institutions have not succeeded in reducing financial exclusion, poverty, and income inequality. Scant access to basic financial services remains a deprivation suffered by large segments of the population. Policymakers are increasingly recognizing that despite a significant growth in profitability and efficiency, banks have been unable to reach vast segments of the population, especially the underprivileged sections of the society (Pierce, 2011). To this end, the onus of policymakers is to create effective opportunities for financial development and inclusion. Key to such interventions are policies that accelerate the introduction of innovative technology, regulatory reforms, and the acquisition of infrastructure that reduce transaction costs and allow the delivery of financial services more rapidly, efficiently and conveniently to broad sections of the population.

3. Approaches

During the past decade, several leading studies like for instance, Honohan (2004), and Demirguc and Klapper (2012), among others, established a strong link between financial access to banking services and economic development and growth. Empirical evidence indicates a distinct rise in income level of the countries with higher number of bank branches and deposits. Higher number of branches and deposit accounts are more observed in high income countries than countries in the low and middle income categories. While these studies show that financial inclusion boost the growth rate of per capita GDP, they do not necessarily suggest that financial inclusion helps the poor. The inability of financial development to reach the poor is evident in several MED countries where there is a perception that financial development and inclusion increase average growth only by increasing the incomes of the rich and leaves behind those with lower incomes. How financial inclusion affects income inequality and how it could improve income distribution in the region is not clear (Dhrifi, 2013). Another little understood area of research in MED is the interplay between financial inclusion and financial stability. In its recent report, the World Bank admits: “there is limited empirical work exploring the specific linkages between financial development and financial stability” (World Bank Brief, 2012). In this policy brief, the empirical analysis estimates first the OLS regressions, which according to the empirical literature are biased and inconsistent. These preliminary biased results are subsequently compared with the more robust, meaningful, and consistent GMM estimators.

The recent global financial and debt crises have brought the focus on financial stability to the forefront (Neaime (2012) & (2016), and Guyot et al (2014), and Neaime and Gaysset (2018)). It is now recognized that financial crises could have damaging effects on the rich as well as on the poor. In particular, people with low levels of income have no headroom to bear downside risks, and their livelihoods can be disrupted by financial instability. Another area where financial inclusion fosters financial stability is by improving the process of intermediation between savings and investments. Today, financially excluded individuals rely primarily on cash

transactions and make their decisions independent of the Central Bank's monetary policy. Financial inclusion brings those individuals into the mainstream and makes the transmission mechanism of monetary policy more effective. Finally, financial inclusion, through careful policy orientation, may help reduce income inequalities, bridge the gap between the rich and poor, and foster social and political stability. This is particularly relevant through the turbulent times many MED countries are currently experiencing.

While several MED countries have taken some steps to enhance financial inclusion and reduce financial instability, progress has been slow across much of the region (Pierce, 2011). Bank penetration and financial services in general have not been able to expand significantly. In the MED region, a number of reasons explain why financial inclusion is low. Among those reasons are: (1) underdeveloped financial infrastructure and lack of credit information; (2) Insufficient competition among banks (which are the dominant financial institutions); (3) Limited availability and diversity of specialized financial products and bank branches; (4) Barriers to women in accessing finance; (5) Poor financial education; (6) Insufficient supervision of microfinance providers; and (7) Little regulatory support of non-bank financial service providers. It is not clear how significant these issues are in explaining the slow pace of financial development and inclusion in the MED region where the research has not kept pace with these glitches. To that end, this brief adds to the limited literature on the MED region, by proposing to assess the state of financial inclusion and stability in the region, in order to identify constraints, opportunities, and priorities for significantly improving access to finance and to address issues such as income inequality, poverty, and financial liberalization and stability. Policy recommendations for improving financial inclusion and reducing poverty and inequality will be developed. In addition, the brief evaluates the effectiveness of the current financial system in reducing financial instability and assesses how increased financial liberalization and integration may be harmful to financial stability. Finally, the brief examines the linkage between financial inclusion and integration on one hand, and financial stability on the other; an area recently recognized to be under-examined by the World Bank in many less developed countries (LDCs) including the MED region.

4. Conclusions

Our empirical results have shown that financial inclusion decreases inequality but has no significant effect on poverty in the MED region. Inflation and population increase both inequality and poverty. Other empirical results have shown that the secondary enrollment ratio, female labor force participation and the trade openness variables are found to significantly affect poverty. While the empirical evidence indicates that enhanced financial integration is a contributing factor to financial instability, an increase in financial inclusion and in population contributes positively to financial stability. This brief also shows that greater access to financial services is positively contributing to the resilience of the banking system deposit funding base. This is particularly important during times of financial crises. Enhanced resilience of bank funding supports overall financial stability of the banking sector and the entire financial system. The latest debt and financial crises have shown that financial liberalization and inclusion in MED may not always be conducive to poverty reduction and financial stability improvements.

More importantly, financial integration in the MED region is found to contribute negatively to financial stability; i.e., an increase in financial integration reduces financial stability. The lack of strong political and economic institutions to supervise and regulate financial markets, especially those which have initiated the liberalization of their markets has been a contributing factor in financial instability. The absence of these institutions could trigger a financial/economic crisis, further widening economic inequality and poverty. Another possible explanation is that increased financial integration of MED's financial markets, mainly those of Egypt, Tunisia, Morocco, and Jordan, in the absence of a well-functioning regulatory environment has caused financial instability and has triggered capital flights. This was particularly the case during the 2008 financial crisis, when Egypt's banking sector experienced a significant outflow of bank deposits, further widening the gap between

the rich and poor and contributing further to increasing the poor segment of the population. Timely financial adjustment measures have, however, prevented a currency and banking crisis to unfold in Egypt; a crisis, which could have been similar to the 2009 Dubai financial crisis, with devastating consequences on a highly growing poor Egyptian population.

5. Implications and Recommendations

Our empirical findings have important policy implications. MED policy makers face tradeoffs when deciding whether to focus on reforms to promote financial development (financial inclusion, innovation, financial access, etc...) or whether to focus on further improvements in financial stability. However, synergies between promoting financial development and inclusion and financial stability can also exist. The results of this brief could help foster a better policy to reform the financial sector by demonstrating how broadening the use of banking can have a direct impact on income distribution.

The recent and uncoordinated liberalization attempts have rendered MED financial and banking sectors more vulnerable to the recent financial and debt crises. In particular, the fast attempts to liberalize and financially integrate the Egypt, Jordan, and Morocco's financial markets with the more mature markets of the United States and Europe has had devastating consequences on their banking sectors and stock markets.

When deciding on whether to focus on reforms to promote financial development (financial inclusion, innovation, access to financial services, etc.) and reduce poverty and income inequality, or on whether to focus on further improvements in financial stability, MED policy makers will have to bear in mind, the tradeoff that exists between financial liberalization and integration and financial stability. Carefully designed financial liberalization policies need to be timely introduced in order not to destabilize the financial system. Moreover, the latest debt and financial crises have shown that financial liberalization and development may not always be conducive to poverty and inequality reduction on the one hand, and to stimulate growth and development, on the other. On the contrary, and in many instances policies aimed at fostering financial development and innovations have triggered recessions and in many MED countries have had detrimental effects on growth and development and have further widened the gap between the rich and poor.

The MED region stands at a crossroad, with changes sweeping many of its countries and creating an environment conducive to financial and economic reform. Having missed a number of opportunities to reduce poverty and inequality, to introduce extensive financial and institutional reforms, and make substantial progress in financial inclusion, more effort still needs to be devoted in the future. The social movements in the region and the earlier series of financial crises have exposed the weaknesses of the adopted financial development model and have raised questions as to how to reshape financial policies most effectively and create the space to address the needs of everyone in society, reaching even the most deprived. The slow pace of financial development and liberalization policies adopted in most MED countries in the past has yielded a relatively acceptable level of economic growth and, in general, managed to meet the goals of economic and financial stability. Oil booms have generated acceptable growth rates, with oil-abundant MED countries delivering much more than those less developed. However, the impact of such economic and financial policy choices has not led to the desired outcomes in terms of human development, poverty reduction and financial stability. Growth has not been inclusive and has widened the gap between the rich and poor; a case in point is Egypt and Morocco. Indeed, in certain cases, financial liberalization has actually contributed to further financial instability. In light of a critical reassessment of the achievements and failures of MED countries, a new financial development approach should be adopted. This new model should be more holistic, integrating the financial and social spheres in combination with strong financial institutions. It is vital that MED policymaking should expand to accommodate these spheres and place them on equal footing in the service of a long-term rights-based financial developmental vision.

The new model will reconsider financial policies that incorporate developmental priorities and would thus achieve structural change. Financial policies will have to be reshaped to achieve not only financial stabilization, adjustment and economic growth, but to also trigger the transformation required to generate growth that is broad-based, inclusive and sustainable. Within this context, such policy tools as financial development and inclusion, and financial sector diversification and liberalization will have to be addressed. At the same time, financial policies should not shy away from meeting the same objectives as social policy under this new financial development paradigm, in which the interests and welfare of every person in society are the target. It is also of central importance to ensure that social policy goes hand-in-hand with financial development policies to bring about the required transformation and ensure inclusive financial and economic growth. While the social and financial spheres should interconnect to create synergies, this new financial development model will not achieve its goals if political and institutional reforms remain shallow. Finally, sustainable poverty and income inequality reduction requires an acknowledgement that politics, institutions, financial and socio-economic policies are intertwined and have an impact on each other. Synchronizing financial and social policies with institutional and political reform would bring about positive, sustainable change under a clearly defined financial development vision.

** The main source of this policy brief is a FEMISE research project (FEM 44-01) titled: Financial Inclusion and Stability in the MED Region: Evidence from Poverty and Inequality (with T-L-Segot and Isabelle Gaysset).*

References

- Demirguc-K. A. and Klapper L., (2012). Measuring Financial Inclusion: The Global Findex Database, WPS6025, the World Bank, Washington DC.
- Dhrifi A., (2013). Financial Development and the Growth Inequality Poverty Triangle. International Journal of Economics, Finance, and Management, Vol 2, No. 7.
- Guyot, Alexis, Thomas Lagoarde-Segot and Simon Neaime (2014) 'Foreign Shocks and International Cost of Equity Destabilization: Evidence from the MENA region', Emerging Markets Review 18: 101-22.
- Honohan, P., (2004). Financial Development, Growth and Poverty: How Close are the Links, in Charles Goodhart (ed.): Financial Development and Economic Growth: Explaining the Links, Palgrave, London, UK.
- Neaime, Simon (2012) 'The Global Financial Crisis, Financial Linkages and Correlations in Returns and Volatilities in Emerging MENA Stock Markets', Emerging Markets Review 13(2): 268-82.
- Neaime, Simon (2016) 'Financial Crises and Contagion Vulnerability of MENA Stock Markets', Emerging Markets Review 27: 14-35.
- Neaime Simon, and Isabelle Gaysset (2018) 'Financial Inclusion and Stability in MENA: Evidence from Poverty and Inequality', Finance Research Letters, 24: 230-37.
- Pearce D., (2011). Financial Inclusion in the Middle East and North Africa, The World Bank Middle East and North Africa Region, Financial and Private Sector Development Unit.

FEMISE MED BRIEF

FEMISE est un réseau Euromed créé en juin 2005 en tant qu'organisation non-gouvernementale (ONG) à but non lucratif après 8 années de fonctionnement.

Le FEMISE est coordonné par le Economic Research Forum (Le Caire, Égypte) et l'Institut de la Méditerranée (Marseille, France) et regroupe plus de 100 membres d'instituts de recherche économique, représentant les 37 partenaires du Processus de Barcelone. Ses principaux objectifs sont:

- de contribuer au renforcement du dialogue sur les questions économiques et financières dans le partenariat euro-méditerranéen, dans le cadre de la politique européenne de voisinage et de l'Union pour la Méditerranée,*
- d'améliorer la compréhension des enjeux prioritaires dans les domaines économique et social et leurs répercussions sur les partenaires méditerranéens dans le cadre de la mise en œuvre des accords d'association et des plans d'action de l'UE,*
- de consolider les partenaires du réseau d'instituts de recherche qui ont la capacité d'interactions Nord-Sud et Sud-Sud, tout en mettant en œuvre un transfert de savoir-faire et de connaissances entre les membres du réseau.*

Tous les policy briefs FEMISE sont disponibles sur notre site web:

www.femise.org



Le policy brief a été réalisé avec l'aide financière de l'Union européenne dans le cadre du programme FEMISE. Le contenu de ce document relève de la seule responsabilité des auteurs et ne peut en aucun cas être considéré comme reflétant la position de l'Union européenne.