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Financial inclusion and stability in MENA: Evidence from poverty and inequality☆

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Despite a significant growth in profitability and efficiency, MENA's 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. Whether they have succeeded in their endeavor is an empirical question we seek to address in this paper. Using Generalized Method of Moments (GMM) and Generalized Least Squares (GLS) econometric models and a large sample of eight MENA countries over the period 2002–2015, this paper assesses empirically the impact of financial inclusion on income inequality, poverty, and financial stability. Our empirical results show that while financial inclusion decreases income inequality, population size and inflation are found to increase income inequality. Other empirical results show that financial inclusion has no effects on poverty, whereas population, inflation, and trade openness are all found to significantly increase poverty. Finally, the empirical evidence indicates that while financial integration is a contributing factor to financial instability in MENA, financial inclusion contributes positively to financial stability.

1. Introduction and related literature

During the past three decades, the MENA region has registered one of the highest rates of unemployment in the world. Frustrated by years of economic and financial exclusion, political instability[1] and marginalization, and income stagnation, young people have taken to the streets and ignited revolutions in Tunisia, Libya, Egypt, Yemen, and Syria. In response, several governments in the region rushed to implement programs that reduce economic and financial exclusion primarily among the poor segments of the population. At the highest levels of political governance, 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 MENA 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

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[1] See also Cumming et al. (2016), for a detailed discussion on how political instability impacts financial innovation and investment.

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payment services) is relatively restricted.

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 poverty alleviation, as the poor find it difficult to accumulate savings, build assets to protect against risks, as well as invest in income-generating projects. Cumming et al. (2014) highlight the importance of access to finance so that entrepreneurs are encouraged to take risk, invest more, and positively contribute to growth. They show that the impact of entrepreneurship on GDP/capita is indeed significant.[2] In some MENA 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 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]

During the past decade, several leading studies (Honohan, 2004; 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 levels of the countries with higher number of bank branches and deposits. Higher number of bank branches and accounts are more observed in high income countries than countries in the low and middle income categories. While these studies show that financial inclusion boosts the growth rate of per capita GDP, they do not necessarily suggest that financial inclusion helps the poor. The low access to banking services by the poor is evident in several MENA countries where there is a perception that financial inclusion increases average growth rate of GDP only by increasing the incomes of the rich and leaves behind those with lower incomes.[4] 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 MENA is the interplay between financial inclusion and financial stability. In a recent Cull et al. (2012a), the World Bank admits: "there is limited empirical work exploring the specific linkages between financial inclusion and financial stability."[5] The recent global financial crisis has brought the focus on financial stability to the forefront. It is now recognized that financial crises could have damaging effects on economic growth and social welfare.[6] While financial instability can hurt even the most advanced economies, the damage it can cause in the MENA region can be particularly severe. People with low levels of income have no headroom to bear downside risks, and their livelihoods can be disrupted by financial instability.

This is where financial stability can make a significant positive contribution in the MENA region. For banks, financial stability helps provide a more stable base of deposits. As the recent global crisis demonstrated, stable retail sources of funding (as opposed to reliance on borrowed funds) can greatly enhance the resilience of banks. Low income savers and borrowers tend to maintain stable financial behavior in terms of deposit keeping and borrowing. During periods of systemic crises, deposits from low income clients typically act as a continued source of funds even as other sources of credit dry up. Small customers, thus, provide big opportunities to garner stable deposits. In the absence of such deposits, banks may find it difficult to continue lending. This credit channel has the potential to aggravate the impact of the crisis on the local economy more than would otherwise be the case.

Another area where financial inclusion fosters financial stability is by improving the process of intermediation between savings and investments. A wider customer base for banks expands their balance sheets to new areas of business and makes them more risk diversified and resilient to withstand unexpected losses. Also, on a pure macro level, financial inclusion attracts a greater participation by different segments of the economy to the formal financial system. 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.[7] 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 MENA countries are currently experiencing.

Using GMM and GLS econometric models and data from eight MENA countries over the period 2002–2015, this paper assesses empirically the impact of financial inclusion on income inequality, poverty, and financial stability. While the empirical literature on the MENA region is relatively scarce, this paper 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 MENA countries. The remainder of the paper is divided as follows. Section 2 highlights the data sources and sample and lays down the empirical methodology and the motivation of the empirical models to be estimated. The empirical estimation and results are all summarized in Section 3. Finally, the last section offers some conclusion and policy recommendations.

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[2] See also Cumming and Uzuegbunam (2016). "Inequality, Entrepreneurial Activity and Poverty Alleviation" SMS Conference, Berlin.

[3] Keynote speech by Masood Ahmed, Director of the Middle East and Central Asia Department, International Monetary Fund (IMF), at the Arab Policy Forum on Financial Inclusion in the Arab World, Abu Dhabi, December 10, 2013.

[4] See for instance: Greenwood and Jovanovic (1990), Lundberg and Squire (2003), Beck et al. (2007a, b), and Mora et al. (2013).

[5] A World Bank Brief, Cull et al. (2012b).

[6] For a detailed discussion of the recent debt and financial crises and their spillover effects on the MENA region see Neaime (2012, 2015a, b, 2016), Neaime and Gaysset (2017) and Guyot et al. (2014).

[7] Keynote speech by Frank Moss, Director General of the European Central Bank, Frankfurt, June 28, 2013.