By Invitation:

Extending **financial services** to Latin America's poor

The president of the Inter-American Development Bank argues that achieving greater "financial democracy" is crucial for achieving greater inclusiveness, improving social cohesion, and generating broad-based growth.

Luis Alberto Moreno

Economic development, according to the Inter-American Development Bank (IDB), is for people—for citizens. If the benefits of economic growth fail to reach a majority, in the long run there can be no development. Over the past 3 years, Latin America has enjoyed its strongest cycle of economic growth in nearly 30 years. Remarkably, this expansion has been accompanied by low inflation, falling fiscal deficits, and current-account surpluses, and it has occurred amid the most active electoral calendar in the region's recent history. But conditions for the majority of Latin Americans have not improved substantially. Calls for change are thus being heard again and again. Without change and real improvements in the people's well-being, the legitimacy of the development effort will continue to be called into question.

Development is a combination of good policies, both macro- and microeconomic. The development of regions such as Southeast Asia, for example, was based largely on the application of numerous microeconomic instruments, backed by stable macro frameworks. In Latin America, despite remarkable achievements at the macro level, we have often neglected the micro dimension of development; we have fallen short in creating and distributing opportunity. The region's per capita income has barely doubled over the past 45 years, whereas in South Korea it has increased 15-fold. Poverty

Article at a glance

In the past few years, Latin America has enjoyed considerable economic success, but conditions for the majority of the region's citizens have not improved substantially.

Despite remarkable accomplishments at the macro level, Latin American leaders have often neglected the micro dimension of development. Financial markets have an important role to play here.

Financial development empowers individuals to achieve their full potential as producers, savers, investors, and consumers.

Building well-functioning financial and banking markets that could promote greater "financial democracy" should be a policy priority for governments and development finance institutions alike.

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and inequality ratios have been stagnant in Latin America, and a large proportion of our people still await the promised fruits of progress.

Going forward, we need to focus our attention on expanding opportunities at the base of the economic pyramid, which represents a large majority of Latin Americans. Few areas will be more important in this effort than building deeper, more inclusive financial markets.

The role of financial markets and systems

Financial markets have a key role to play: there is ample evidence of the relationship between their development and economic growth, and I doubt that anyone disputes the link between a system's depth and coverage and the reduction of poverty. Achieving well-functioning financial markets and institutions, which leverage savings and channel them into productive investments, should be a policy priority for governments and development finance institutions alike.

In brief, financial development enables individuals to make the most of their potential and represents a tool for expanding "financial democracy." In Latin America, we have made historic strides toward the consolidation of political democracy, but they have not been accompanied by the democratization of means and opportunities. Financial democracy is fundamental for achieving greater inclusiveness, improving social cohesion, and generating broad-based growth. It is therefore crucial for economic dynamism and political stability.

It is crucial, first, because the lack of financial democracy prevents people from gaining access to resources that would enable them to make the most of their abilities and assets and thus condemns them to a cycle of poverty that is hard to escape. At the IDB we estimate that in 12 Latin American

countries "dead capital" (untitled assets that belong to the poorest people and cannot be mobilized or leveraged) amounts to $1.2 trillion!

Second, micro, small, and midsize enterprises are economically vital to the region, despite their lack of access to adequate financing. They account for 98 percent of all companies and, depending on the country, from 40 to 50 percent of GDP and 40 to 60 percent of employment.

Third, these companies also have great social significance. IDB analyses show, for example, that 70 percent of the region's poorest wage earners are owners or employees of microenterprises. This suggests that we have a significant opportunity to reduce poverty in the region by making financial services more inclusive.

Finally, financial inclusion also generates optimism and confidence in the future. It is impossible to understate the importance of access to financial services for population groups that lack the resources both to escape from poverty and to contribute to economic activity, social cohesion, and political stability. A population that plays an active part in the economic process is much more likely to identify with the rest of society and to have a sense of ownership and belonging, thereby contributing to stability. Belonging means having something to lose, and this sense is fundamental to social cohesion.

Unfortunately, financial systems in Latin America do not play a significant role in the lives of most of the region's inhabitants. The consequent "intermediation gap" is reflected in narrow and shallow financial markets—a phenomenon that inhibits broad-based economic growth and helps to perpetuate inequality throughout the region. Basic financial services, such as bank accounts, credit, and insurance, paradoxically have a higher cost for the vast majority of people at the base of the economic pyramid, and this premium discourages their use.

Gaps in the system

In Latin America, banks are the leading source of financial services. Despite the banks' importance in business financing, the amount of credit extended to the private sector as a percentage of GDP is much lower than it is in developed countries. For Latin America as a whole, total lending to the private sector amounts to only 25 percent of GDP, compared with 76 percent in developed countries.

The IDB recently conducted a detailed study of the region's financial markets. We found that large numbers of people have no access to financial

services. On average, only 10 percent of the population has access to credit; access to other services, such as insurance and the capital markets, is lower still. (Even in the United States, more than 40 million people do not have access to financial services.)

Beyond the banking system, capitalization and liquidity are much lower in Latin America's stock markets than in those of other regions, and the number of listed companies has actually declined over the past decade. Although we have hundreds of thousands of viable enterprises in our region, only 1,648 of them are listed on stock exchanges. Far fewer are actively traded, and, of course, hardly any of the listed companies are small businesses.

In many of the region's countries, financial systems are characterized by large volumes of government-issued debt instruments with maturities that are still skewed toward the short term. This tends to generate atrophy rather than development in the financial system by crowding out private businesses. In Colombia, for example, the public sector absorbs more than one-third of the banking system's lending capacity.

Many financial institutions do not fulfill their true role as intermediaries and instead focus on investing in government bonds, to the detriment of lending to the private sector, admittedly a less straightforward activity. This suboptimal pattern of behavior is strengthened by weak legal frameworks and banking regulations whose chief aim is a stable financial system, even if it does not intermediate! Minimum capital requirements for banks conspire against the system's development. A typical banker's rationale would be, "Let's buy government bonds, since this requires less capital and is less risky and easier."

Moreover, financial institutions, aiming to maximize profits, seek economies of scale and scope and are therefore interested mostly in large urban markets and in large clients. Coverage is limited in more sparsely populated areas, such as the rural sector, and among low-income groups.

Ineffective regulation

Banking in Latin America is often highly regulated, sometimes in unnecessary and counterproductive ways. For example, interest rate ceilings, intended to discourage usury, pose a major obstacle to credit access for informal microenterprises, whose credit risk is high by definition. The issue of usury is as old as the Bible. The negative effect of interest rate ceilings on financial-sector development, while not quite as old, is now well

established. Back in 1714, the lowering of the maximum permissible rate in England reduced access to credit and increased the minimum and average size of loans.

By contrast, in the United States, the Supreme Court's 1978 ruling against limits on rates helped fuel a boom in the credit card market, which today has assets of $452 billion and benefits 60 million families. But this phenomenon is not limited solely to wealthy nations. Countries such as Bangladesh, Indonesia, South Africa, and Thailand, as well as others closer to home—for instance, Bolivia and Peru—have abolished interest rate caps and successfully developed microcredit markets. Perversely, the laudable goal of reducing financing costs for the poor by controlling interest rates has served only to exclude them from the possibility of access to financial services.

Limited competition

Competition too is lacking in Latin America. When financial markets were liberalized and foreign banks admitted to the region, in the 1990s, competition began to flourish and banks were motivated to seek out progressively smaller-scale customers to gain business. This development was highly effective in deepening access to financial services but came at the cost of greater industry concentration. While it is true that concentration allows for economies of scale and scope, which are necessary for a system's efficiency, a balance should be struck between concentration and competition.

In Colombia, for example, thanks to reduced inflation and increased competition, financial spreads have narrowed, and the sector is enjoying an unprecedented boom. Nonetheless, to guarantee its sustainability, competition must be fostered still further. Foreign banks hold only 20 to 25 percent of the Colombian system's assets. The proportion is 40 percent in Chile, 45 percent in Venezuela, 60 percent in Peru, and 80 percent in Mexico.

To be sure, the returns are good. In 2005, for example, profits in Colombia were 4.1 percent of assets, compared with 3.9 percent in Chile and just 1.6 percent in Canada and 1.4 percent in Spain—even though financing to the private sector as a percentage of total assets is just 28 percent in Colombia, compared with 62 percent in Chile, 44 percent in Canada, and 49 percent in Spain. These high returns reflect high intermediation spreads resulting from a lack of competition, which affects Colombia's overall competitiveness.

High profitability is not a problem in itself, but it becomes a problem when it overshadows incentives to increase coverage. In Colombia the use of bank accounts is very low: on average, over the past five years, credit totaled only 19 percent of GDP, as opposed to 59 percent in Chile and 118 percent in Spain. In Bogotá and in São Paulo fewer than 40 percent of families have access to the financial system. In Mexico City the figure is under 25 percent. The number of ATMs per 100,000 people is 127 in Spain but 24 in Chile and just 10 in Colombia. Administrative costs in Colombia as a percentage of total assets are more than twice those in Chile and more than three times those of developed countries.

Low lending to the private sector and its consequences

Over the past two years, the banking system's liquidity has increased significantly in Latin America, but only Brazil and Chile have regained the levels of lending to the private sector that prevailed in the 1960s. In Argentina and Venezuela, levels of credit to the private sector are one-fourth to one-fifth of what would be justified by their overall levels of economic activity. Only in Chile is lending to the private sector at a level greater than the country's GDP would warrant. Lending to governments and to large customers not only is easier and more profitable but also requires less capital. This state of affairs is promoted by banking regulations that give preference to stability over intermediation. It is not sustainable, however. If the banks fail to deepen and extend their coverage, technological progress will provide increased opportunities for fund transfers and intermediation outside of the banking infrastructure.

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In some countries, such as South Africa, where the use of bank accounts is low, we are already seeing the emergence of systems that use smart cards and prepaid cellular telephony to facilitate transactions between individuals and between them and commercial entities—without the need for a banking infrastructure. Last year Wal-Mart Mexico announced plans to enter banking, following the lead of successful domestic retailers, such as Elektra. Governments have promoted these channels as a means of democratization, using them to deposit public transfers such as pensions, tax rebates, and conditional transfers to low-income population groups, among others. Of course, the corresponding transaction costs are much lower than those for payments using credit cards or checks, which do not reach

lower-income groups. These are the channels of the future for the remittances of migrants.

South Africa has also been a pioneer in establishing a universal-access fund for financial services, similar to the funds many countries use to promote cellular telephony. Banks contribute to the fund and in exchange receive resources from it as they expand access. Why not consider adopting such a mechanism, which benefits people and deepens the system, in Latin America?

Concerted action

The reality of low bank account use, low inclusion, and low capital markets development in Latin America needs to change radically not only for the good of the region but also for the stability and long-term profitability of its financial systems. This goal requires concerted action by the public and private sectors.

It is time for financial institutions to accelerate the development of innovative mechanisms and new programs to reach the microfinance, remittance, and other underserved markets. If Latin American financial institutions exploit this opportunity, we will have taken a major step toward improving the lives and possibilities of the majority of the region's inhabitants. From the standpoint of financial institutions, such moves represent an opportunity to open up a potentially enormous and profitable market.

In my opinion, we are living during a "perfect storm" for financial democratization in Latin America. Inflation rates are at record lows, economies are growing, banks are profitable and well capitalized, and technology is enabling us to reduce costs and increase coverage. All of this means that, perhaps for the first time in the history of the region, significantly extending banking coverage makes good business sense. The opportunity must be seized now, while the financial system is not under pressure, to give financial democracy the attention it has thus far lacked.

The base of the pyramid

My top priority at the IDB is to help ensure economic and social progress among neglected population groups. For that reason, we have launched the "Opportunities for the Majority" initiative, with a program of activities to improve the quality of life for these groups. Poor population groups pay what is in effect a fine—a tax for being poor—in forms such as higher costs to obtain potable water, hours wasted through a lack of adequate transport, and working days lost to easily preventable illnesses. Yet these

people represent the backbone of our societies and should be the focus of our efforts.

One of the pillars of the initiative is financial democracy. In addition to supporting the development of financial markets, we aim to help triple the volume of microcredit in the region, targeting a level of $15 billion in five years. We will also work to reduce the average cost of remittances by migrants—crucial to the lives of millions of poor families in the region—to 3 percent, from the current 5.6 percent. And we will create a new $1 billion lending program for small and midsize enterprises, as well as increase our funding for job training by 50 percent, to $2 billion, in the next five years.

In addition, affordable products and services must be developed to meet the needs of the majority. Such offerings would help to create job opportunities, which are fundamental for reducing inequality and poverty. I firmly believe it is possible to generate attractive commercial profits in addition to social returns. But doing so will require a step forward from traditional strategies. Under the new paradigm, it is essential to develop public policies with well-structured incentives. As a result of greater competition and narrower spreads, some financial institutions have already started to provide financing and banking services to small and midsize enterprises, microenterprises, and low-income families. There has also been some expansion of the frontier in microfinance products: credit and debit cards, micromortgages, agricultural loans, savings accounts, microinsurance, and remittances, as well as a number of informal mechanisms for assisting low-income groups.

The poor constitute a major new market segment, which has so far been underserved by the banking system. This segment, which includes a massive and stable customer base, will help to diversify portfolio risk in the region. Experience shows that using appropriate credit evaluation techniques can reduce the risk posed by the microfinance segment to levels equal to or lower than those of traditional segments.

Growing volumes of remittances, generally reaching low-income groups, are currently used mostly to finance consumption. Few of the recipients open or hold bank accounts that could help put such resources to productive use. There are significant opportunities to offer both deposit and loan products to these people.

Financial institutions will have to overcome an organizational culture that does not see this market segment as attractive. To do so, senior management must embrace this new line of business. Companies will have to develop

a deeper knowledge of the new customers and market segments in order to design specialized products, to deploy more flexible and customized processes and credit and service technologies, to retrain employees, and to establish new distribution channels that can serve this market effectively.

I intend to strengthen the IDB's commitment to work with governments in implementing the legal and regulatory frameworks needed to ensure that these new initiatives can flourish.

It is impossible to overstate the importance of the people, the enterprises, and the economic activity at the base of the pyramid. If we satisfy the needs of the base, our region's economy will grow rapidly and more equitably, and its financial systems will expand and become better equipped to cope with the instability of business cycles. It is also no stretch to claim that this is good business—something many commercial banks have discovered, having already undertaken the downscaling needed to serve these customers.

The future growth and development of Latin American countries will depend largely on their own ability to provide key services more inclusively. This is particularly true of financial services, which are crucial to help the people develop their full potential as entrepreneurs, workers, consumers, and investors. Q

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