SUMMARY POVERTY IMPACT ASSESSMENT

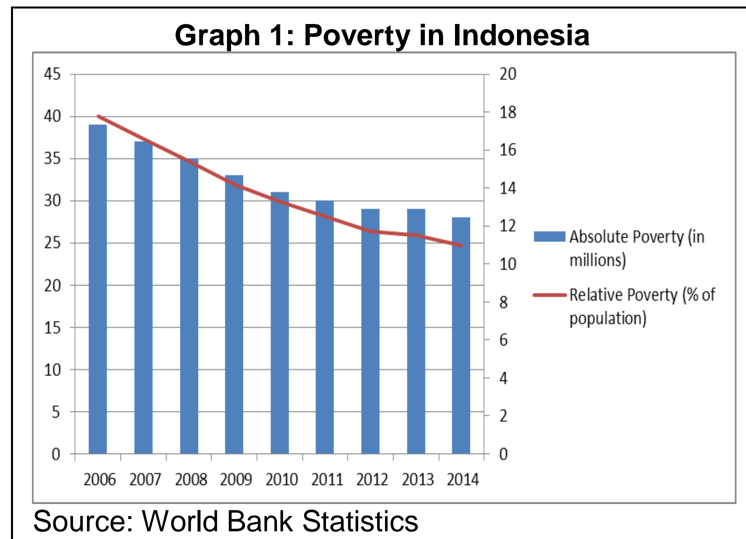
A. Introduction

1. This Poverty Impact Assessment (PovIA) describes, in general, how financial sector development reduces poverty as well as how FMDIP is expected to contribute to poverty reduction in Indonesia[1]. The assessment starts with a brief review of the international evidence on the nexus between financial sector development, financial stability and poverty reduction. The assessment then describes the channels through which FMDIP will contribute to poverty reduction in the medium to long term, including (i) indirectly through economic growth and financial stability and (ii) the more direct channel of access to finance for the poor. The direct role played by Islamic finance is also discussed.

B. Background

2. Indonesia's national development plan is anchored on the National Long-term Development Plan (RPJPN) 2005–2025. Within this framework, the Government develops medium-term development plans (MTDP) every five years. Poverty reduction has always been a primary focus of these medium-term development plans with previous plan covering periods 2004–2009 and 2010–2014.

Graph 1: Poverty in Indonesia



Source: World Bank Statistics

The reduction in poverty rates to date has been impressive, given that the rate in Indonesia was as high as 17.8% in 2006 (Graph 1). At 11% in 2014, the country came close to the targeted rate of 8-10% which was to be achieved by year-end 2014. However, to reach the 2019 target rate of 7-8%, a number of factors that continue to hamper the Government's efforts will need to be addressed. These factors include increasing income inequality (see Graph 2), the large percentage of the population considered to be "near poor" and limited coordination between sectors and between the central and local governments.[2] Graph 2 shows that per capita expenditure of the lowest income groups decline while spending among the richest 20% of the population increased in real terms leading to a surge in inequality as measured by the Gini index. Under the MTDP (2015–2019), the Government has targeted 8% economic growth by 2019, over 5.1% in 2014, and a targeted poverty rate of 7–8% by 2019. To decrease the gaps between economic groups, the plan looks to develop a comprehensive social protection system, improve basic services for the poor and marginalized segments of society and develop sustainable livelihoods for the poor. The Government has identified access to finance as a key way to reduce the income gaps and expects to have 25% with access to formal financial services over a 2014 baseline of 4.12%. The Government has identified the financial markets as a major source of economic growth in

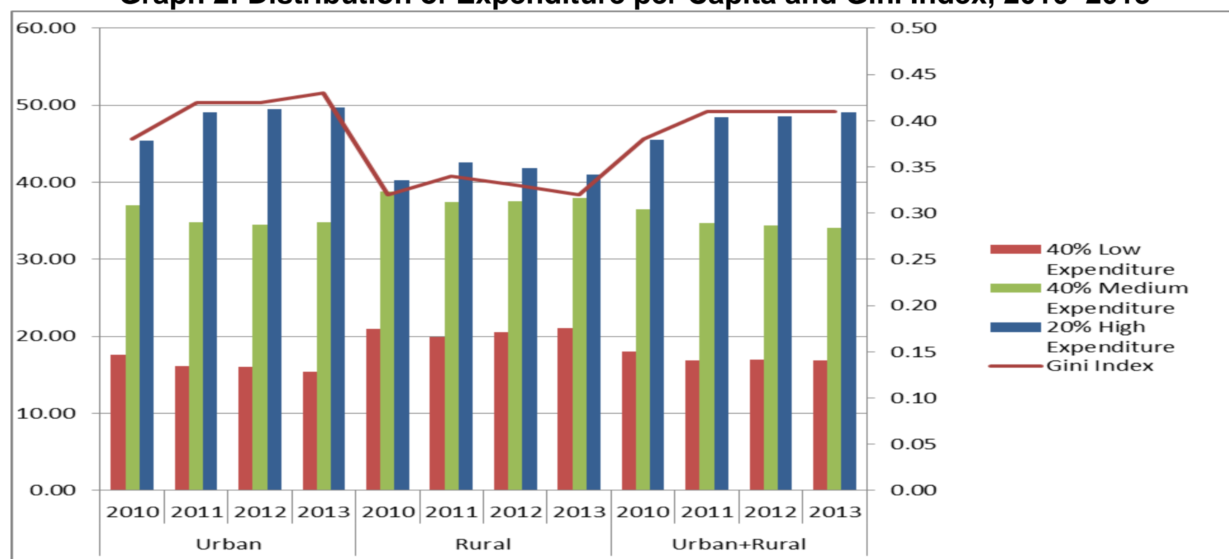
---

1 This Poverty Impact Assessment is an update to the document prepared for FMDIP1 in 2013.

2 October 2010. SEMRU Research Institute, *Review of Government's Poverty Reduction Strategies, Policies, and Programs in Indonesia*.

the country, reflecting the government's commitment to, and belief that financial sector development helps to reduce poverty.

Graph 2: Distribution of Expenditure per Capita and Gini Index, 2010–2013

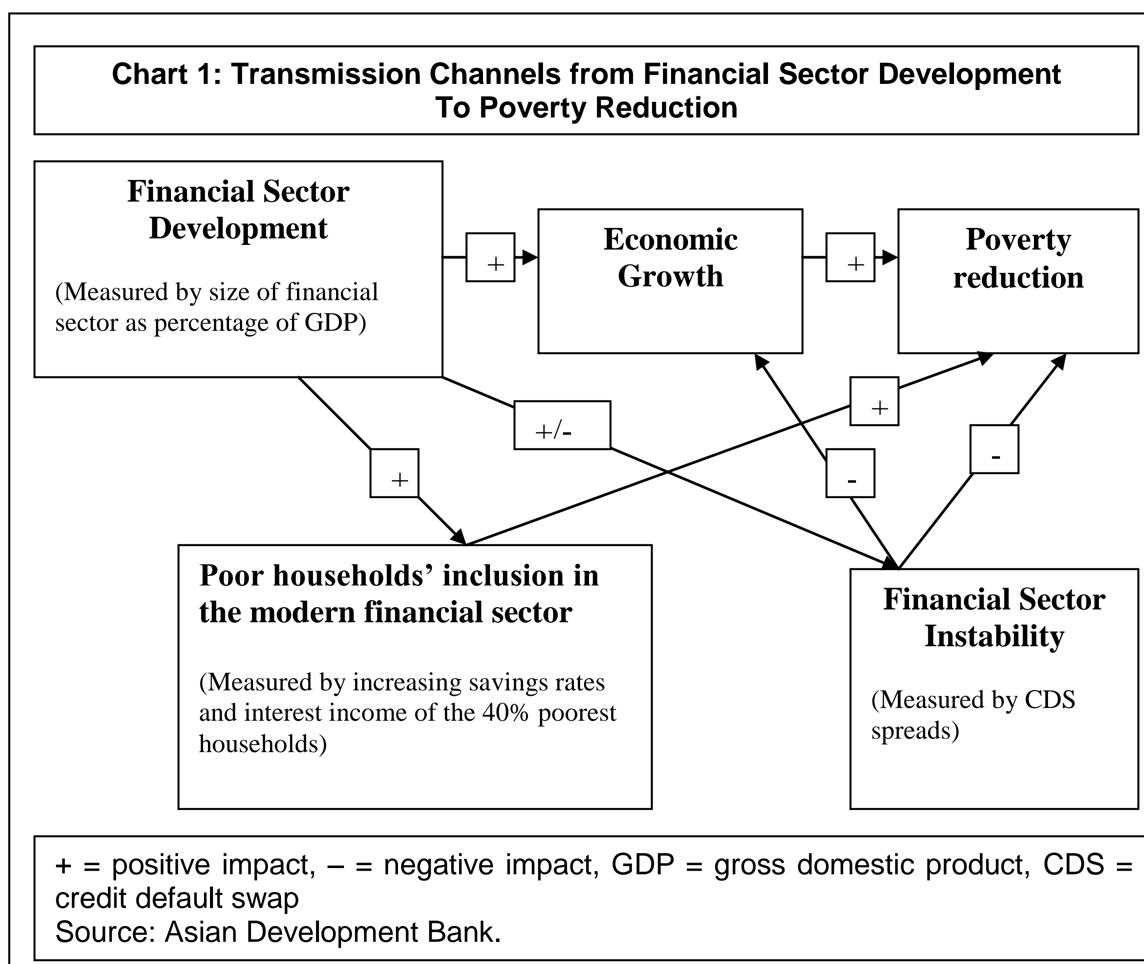


Source: Based on National Socio Economic Survey Quarter I BPS-Statistics Indonesia

Notes: Calculated with individual data, not expenditure group data as used in 1996-1999 methodologies.

C. Impact of Financial Sector Development on Poverty

3. Financial sector development helps reduce poverty through three primary channels; higher economic growth, financial sector stability and access to finance for the poor, the first two are indirect and the last is direct. The link between financial sector development and poverty reduction is summarized in Chart 1 below:



4. First, there is general consensus that economic growth reduces poverty reduction through (i) job creation, (ii) increasing tax revenues which can be used for social welfare programs and reform such as education and health which typically benefits the poor, and (iii) higher capital accumulation even amongst the poor which can be used for investment to get higher returns and income.[3]

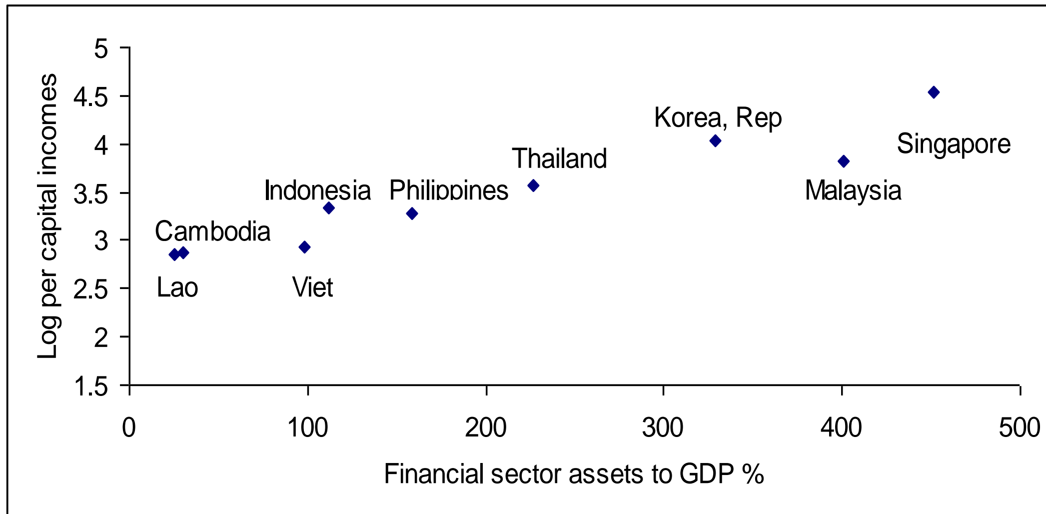
5. **Financial sector development and economic growth.** The link between financial sector development and economic growth has seen extensive debate. Economists, backed by empirical evidence have recently agreed that the nexus between financial sector and economic growth is real and countries with better functioning banks and financial markets grow faster. More crucially, some studies have gone to prove that the reverse is not necessarily true, thus disproving the reverse causality.[4] Graph 3 on the next page demonstrates this link.

---

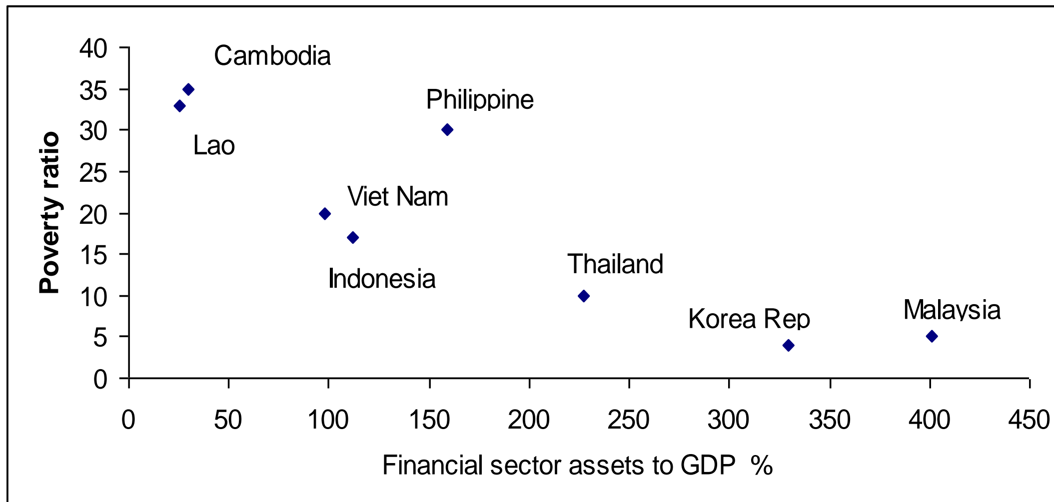
[3] ADB's working paper 173 on Financial Sector Development, Economic Growth, and Poverty Reduction: A Literature Review, October 2009.
[4] For a more through discussion and literature review of this, please see ADB's working paper 173 above.

Graph 3: Financial Sector Development, Per Capita Incomes and Poverty Reduction in East Asia

(a) Financial sector development and per capita incomes



(b) Financial sector development and the incidence of poverty



Notes: Financial sector development measured by the ratio of financial sector assets (bank loans, bonds, and stock market equity) to GDP. Economic advancement measured by per capita incomes. Poverty measured by the headcount to total population.
Source: CEIC and ADB staff estimates.

6. Financial sector development leads to economic growth in five distinct ways. First, developed financial systems that are more effective at pooling the savings of individuals, exploiting economies of scale, and overcoming investment indivisibilities. As a consequence, rates of private investment and household consumption increase over time leading to higher

economic growth and poverty reduction. Financial sector development also produces intermediaries that reduce information costs through specialization and economies of scale and thereby improve resource allocation and accelerate growth. Third, a developed financial sector with adequate monitoring systems and corporate governance standards encourages those with surplus finance to invest for production, innovation and Greenfield projects. Fourth, a developed financial system will provide risk diversification benefits which encourage long-run economic growth by improving resource allocation. Finally, the financial sector facilitates trading of goods and services, and promotes specialization and technological innovation. Specifically the role of capital market development is also important as public listings provide an avenue for small investors to participate in privatizations and stock markets provide complementary risk diversification that facilitates the efficient allocation of credit.

7. The second channel or link between financial sector development and poverty reduction is that financial sector development generally increases financial sector stability. Poor households are much more vulnerable than the rich to instability in the financial sector as the poor have fewer and less diversified financial assets than the rich. For example, rich households are more likely than the poor to have assets indexed to inflation.[5] Often times, instability in the financial sector arises during the earlier stages of financial sector development as the financial regulatory and enforcement architecture is not fully effective. The resulting policy responses such as large scale bank closures tend to hurt the poor the most by exacerbating problems with the payments system and through a loss of deposits. Furthermore, financial sector instability is often accompanied by a credit crunch wherein banks often require higher pricing and more conservative collateralization which disproportionately affects the poor. Thus, financial sector reforms that aim to enhance financial sector stability also help reduce the vulnerability of the poor or near poor falling into poverty arising from financial sector crises.

8. The third channel of financial sector development that directly reduces poverty is through access to finance, particularly for the poor. Financial sector development reduces informational asymmetries which produce credit constraints. These constraints typically hurt the poor who do not have the resources to fund their own projects, nor the collateral to access bank credit. Through better access to credit, the poor are given the opportunity to participate in meaningful economic activity and undertake investments which increases their incomes. Furthermore, by expanding the access of the poor to financial services, they can increase their lifetime income through the use of basic savings products such as bank accounts, and special purpose savings products such as pre-need plans and pensions. Islamic finance plays a crucial and distinct role in reducing poverty by through this channel. Studies have shown that a segment of Muslim populations abstain from holding conventional savings accounts due to the interest-generating feature which is prohibited in Shariah (Islamic law). Similarly, some abstain from conventional investment instruments as they prefer investments which are compliant with Shariah. Islamic finance provides alternatives, in terms of both savings accounts and investment instruments through the profit sharing structure offered by Islamic financial institutions (IFI).[6]

9. **Empirical studies confirm the relationship between financial sector development and poverty reduction.** A recent IMF working paper estimated the quantitative impact of financial sector development on poverty in 65 developing countries. The study found that:

---

[5] G. Jeannwney, S. and K Kpodar (2008), *Financial Development and Poverty Reduction: Can there be a benefit without a cost?.* IMF Working Paper #62. Washington DC. The authors estimated quite large coefficients on the financial sector development variable – a 10% increase in the broad money (M3) to GDP ratio raises the incomes of the 20% poorest households by between 3 and 5%.

[6] Mohieldin, Iqbal, Rostom and Fu, "*The Role of Islamic Finance in Enhancing Financial Inclusion in OIC Countries*", World Bank, December 2011.

(i) financial sector development raises economic growth and reduces poverty; (ii) financial sector development directly reduces poverty by raising the investment and interest incomes of the 20% poorest households; and (iii) financial sector instability directly reduces incomes of the poor thereby raising poverty.[7]

10. Similarly, a study by Beck, Demirgüç-Kunt, and Levine (2004) using data for 58 developing countries over 1980 to 2000 showed that countries with better-developed financial intermediaries (measured as the ratio of private credit to GDP) experience faster declines in both poverty and income inequality by disproportionately boosting the incomes of the poor. In addition, the studies revealed that industries composed of smaller firms grow faster in countries with a better-developed financial sector. This reflects the fact that small firms such as SME's generally face greater barriers to raising funds than large firms, and thus, financial development is particularly important for their growth. Moreover, a recent ADB study on financial development and economic growth in developing Asia (2010) shows that financial depth, using different measures of liquid liabilities, private credit and stock market capitalization all exert significant positive effect on real per capita GDP growth.[8]

11. These studies confirm the earlier findings of Li, Squire, and Zou (1998) that financial depth (measured as the ratio of broad money supply [M2] to GDP) is associated with lower inequality and also higher income of the lower 80% of the population. The regression results suggest that a one standard deviation increase in financial depth would result in an increase of US$3,000 in the incomes of the poor but only an increase of US$1,600 in the incomes of the rich. Another study by Honohan (2004a) appeared to confirm that a 10 percentage-point increase in the ratio of private credit to GDP would lead to a 2.5–3.0 percentage-point reduction in poverty incidence.

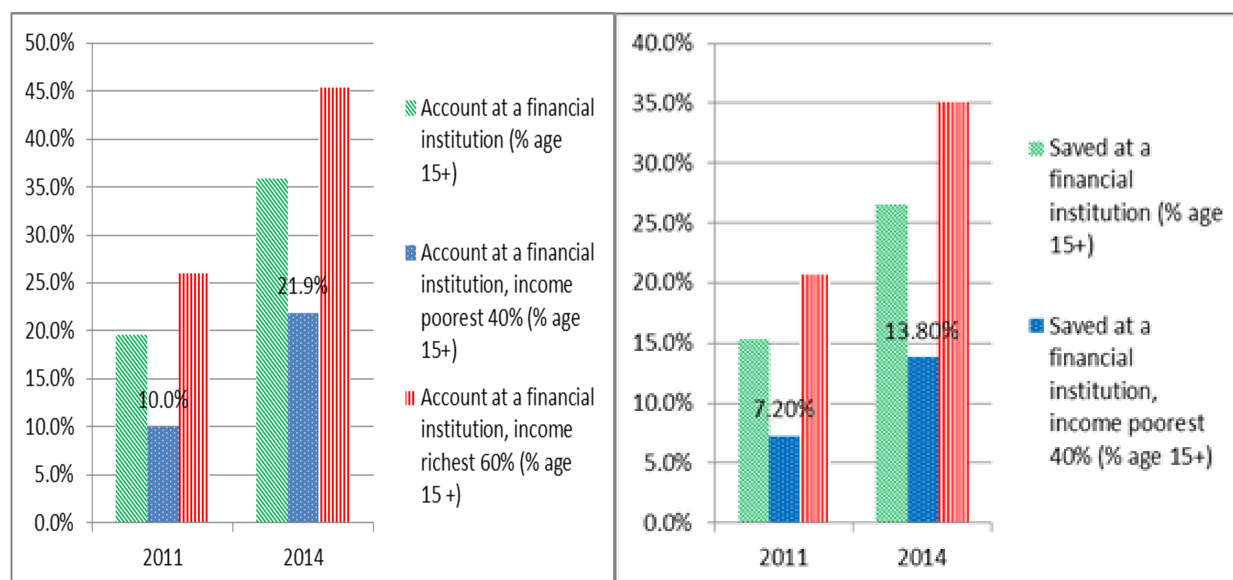
C Financial Access of the Poor in Indonesia

12. Financial exclusion is a development problem in Indonesia, related to an underdeveloped financial sector. Graph 4 demonstrates the disparity between the poorest 40% and richest 60% of the population. In 2014, only 21.9% of the poorest 40.0% of the Indonesian population has savings at a financial institution compared to 45.3% of the richest. Similarly only 13.8% of the poorest compared to 35.1% of the richest save at a financial institution. This means that the poor not only do not generate any returns from their income but that their income is also subjected to risk including natural disasters such as flooding and earthquakes. Furthermore, over 40% of the population does not borrow, with only 13.1% having borrowed from a financial institution. From those who do not borrow, 60% said they are not considered creditworthy. This suggests that the financial services provided may not be suitable for all segments of society. In addition, while a sizeable percentage of those who do not save cited lack of resources and employment as contributing factors, 7% said they either do not understand financial services or see no benefit in it. Comparing the different financial subsectors, capital market literacy is the lowest, with close to 94% categorized as not literate. the key reasons behind the financial exclusion are low access to financial services, low level of financial literacy, and weak consumer protection.

[7] Jeanneney, Sylviane Guillaumont and Kangni Kpodar, March 2008, "Financial Development and Poverty Reduction: Can There Be a Benefit Without a Cost?" IMF Working Paper WP/08/62.

[8] Estrada, Park and Ramayandi, "*Financial Development and Economic Growth in Developing Asia*", ADB Economic Working Paper Series, November 2010, Manila.

Graph 4: Comparison of account and savings between poorest 40% and richest 60% of the population



Data from database: Global Findex (Global Financial Inclusion Database)

D. Contribution of FMDIP to Poverty Reduction in Indonesia

13. **A strengthened regulatory structure for financial stability under** FMDIP will continue with the ADB sponsored initiative to provide for independent, harmonized and comprehensive regulation and supervision of the financial markets through the creation of an Integrated Financial Services Authority, Otoritas Jasa Keuangan or "OJK" with the goal of mitigating financial systemic risks and enhancing financial sector stability. By establishing an integrated supervisory framework and operations within OJK and strengthening a coordination mechanism for financial sector stability, FMDIP will help to mitigate these risks and will continue progress made in building the capacity of OJK to support the economy through financial sector development. Research highlights the importance of maintaining sound macroeconomic management and effective financial regulation and supervision. There is a view that financial sector development also increases the opportunities for speculation, increasing volatility and the risk of financial crises. In fact, one study (Arner; 2007) argues that financial crises in emerging economies around the world over the past 20 years highlight the dangers inherent in financial liberalization without first addressing institutional weaknesses in the financial sector such as poor regulation and supervision and weak corporate governance. In the case of Indonesia, the recent credit rating upgrade has led to an influx of investment, and will further increase Indonesia's exposure to global contagion through capital flows and exposure to sophisticated and inter-linked investment schemes.

14. **A deeper financial market will reduce poverty by enabling higher economic growth.** A deeper and more diversified financial sector helps to serve as a foundation for long-term financing for infrastructure which benefits all segments of the population. This links to an earlier point regarding financial sector development and its contribution to economic growth reflected by the fact that developed financial systems are more effective at pooling the savings of individuals, exploiting economies of scale, and overcoming investment indivisibilities. FMDIP Subprogram 1 supports government and OJK in adopting international standards and enhancing the enabling environment for financial markets. Additional reforms under FMDIP

further strengthen governance and risk management in the contractual savings industry, particularly those regulations that deal with implementation of the new Insurance Law. The Government has recognized the need to increase the size of the domestic investor base and to encourage the accumulation of long term savings and funds. To support this objective, and to achieve the full benefits of coordinated financial market development, FMDIP will simultaneously increase the contractual savings sector's demand for capital market products. To broaden the investor base, the development of Islamic Finance will be encouraged including introducing appropriate prudential frameworks. This should lead to increase issuance of corporate Sukuk as well as narrowing of spreads between Sukuk and corporate bonds. Islamic finance also has an important role in financial inclusion as it introduces a number of financial products for the poor.

15**.** **Enhancing access to financial services** is a key pillar of FMDIP. The strategy is by broadening financial inclusion and literacy. Subprogram 1 supports the government and OJK in (i) broadening financial inclusion and literacy, and (ii) strengthening consumer protection. The Government of Indonesia acknowledges the importance of microfinance to the national economy and therefore promulgated the Law of Microfinance in 2013 highlighting the need to supervise the financial activities stemmed from microfinance institutions. Government is currently working on finalizing a National Strategy on Financial Inclusion which will seek to harmonize financial inclusion activities across Government ministries.

16. One of the recent efforts undertaken by OJK to increase financial inclusion was the launching of Indonesia`s National Strategy on Financial Literacy (SNLKI) on 19 November 2014. The strategy is based on the idea that (i) less complex products are more easily understood by the public; (ii) there is positive correlation between higher income and financial literacy; (iii) higher education means higher financially literate; and (iv) many people don't understand capital market products. The national strategy was based on findings from a national survey on financial literacy conducted by OJK in 2013 in 20 provinces and involving 8,000 respondents. The survey indicated that financial literacy in Indonesia is low, with only 21.8% of the population being considered financially literate. The survey showed strong potential for using financial literacy to improving utilization of financial products and services. Both the National Strategy for Financial Inclusion and the National Financial Literacy Strategy will be implemented during the period of Subprogram 1, 2015–2017. Promoting financial inclusion is an opportunity to address this development problem, as increasing basic savings and investments—especially among the poorest population—can raise income levels and reduce gaps in income distribution.

17. Finally, FMDIP will support the strengthening of consumer protection measures at all levels of the financial market from capital market investors to retail investors. Greater levels of consumer protection will help ensure quality access to financial services to all Indonesians.

Table 1: Poverty Impact Assessment

FMDIP will contribute to sustainable reduction in poverty in the short and medium term through three channels. The first channel is increase in financial sector stability through strengthening the financial sector regulatory architecture. The second channel is through development of the financial market. The third channel is through increased access to financial services for low income and poor households through increased financial inclusion, financial literacy and consumer protection.

Channel of Effect		Effects on the Poor			
General	**Specific**	**Direct Short Term**	**Indirect Short Term**	**Medium Run**	**Mitigation or Enhancement Measures**
Strengthened regulatory structure for financial stability	Improved coordination among financial sector regulators, enhanced regulatory and enforcement capabilities of OJK, other measures will support financial sector stability			Macroeconomic stability (i.e., low inflation and low growth volatility) will reduce risks of external shocks to low income households and the poor.	OJK is developing a consolidated financial sector road map which will cover financial stability including coordination mechanism between MOF, BI and OJK
Deepened financial markets and investment opportunities	Improved the enabling environment for financial market development by diversifying capital market products on the supply side and reforming the contractual savings sector (insurance and pension) on the demand side.		Increase in private and public investment will support expansion of near-term economic opportunities and growth.	Investment will create employment and generate earning opportunities for the low income households and the poor.	OJK is developing a consolidated financial sector road map which focuses on integrated financial sector development including capital market and Islamic finance
Enhancing access to financial services	Poor to benefit from financial services primarily savings products that increase their lifetime income and enhance their ability to undertake profitable investments and other activities. Consumer protection especially benefits the poor as they are susceptible and hardest hit by fraud and other financial offences	Increase access to financial services through microfinance institutions, design products appropriate for the poor, and financial literacy programs	Better consumer protection increases confidence of the poor to save and invest in financial institutions and products		OJK has developed the National Strategy on Financial Literacy, which will be updated in 2016, and the government is finalizing the National Strategy on Financial Inclusion. ADB is also supporting OJK to complete a sector assessment on micro-finance.

Source(s): Asian Development Bank.