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Promoting Pro-poor Growth
Policy Guidance for Donors

PART II

Chapter 9

The Financial Sector's Contribution to Pro-poor Growth

Why is the topic important for pro-poor growth?

First and foremost, a well-developed financial sector – understood as the central bank, commercial banks, non-banking financial institutions (which include microfinance institutions and alternative finance institutions such as co-operatives, credit unions and savings banks), as well as the financial markets – is important for promoting private sector development and subsequently the contribution of the private sector to alleviating poverty.

The financial sector contributes to reducing poverty and improving opportunities for the poor directly, indirectly and by making economic growth more pro-poor.

The financial sector can have a more direct impact on poverty reduction in two ways:

i) A well-developed financial system allows the poor to have access to financial services, which they are often denied. They need to have access to a large array of financial services, such as saving facilities, payment instruments, credit, and insurance. When the poor accumulate savings as a precaution against unforeseen events or with a view to financing investments in housing or child education, it is important for them to have their savings in liquid assets and in a safe place. They also need credit on various occasions: to finance equipment or inputs needed for revenue generating activities, to pay for education or to help them recover from difficult situations resulting from economic crises, natural disasters or health accidents. Credit is of particular importance in rural areas where farmers have to face a time lag before they receive the proceeds from selling their crops. They also sometimes suffer from drought, flood or shocks. There is increasing evidence of the ways in which financial services touch the lives of poor directly.[1] However, in the absence of well-functioning formal markets, individuals and firms seek other less efficient means of risk management. Informal systems are common in the early stages of development. As they emanate from local cultures and customs, the procedures are simple and easily understood by the population, but such systems are usually characterised by high risks and usurious rates of interest.

ii) The financial sector can facilitate the financing of investments for the provision of basic services to the poor. Improving access for the poor to basic services such as water distribution, power, health services and education is necessary to reach the Millennium Development Goals. However, current volumes of official development assistance (ODA), foreign direct investment (FDI) and domestic savings fall short of what is needed to finance the corresponding investments. Additional private resources will be required to augment those coming from the public sector. A sound financial sector will not only reassure private investors but also facilitate financial flows and create new opportunities.

The financial sector can also contribute to poverty reduction indirectly, as a diversified and competitive financial sector plays an important role in economic development generally. Indeed, a well-functioning financial sector contributes to the maintenance of economic stability; it provides a means of payment and makes possible secure financial and commercial transactions; it helps to mobilise domestic and external savings; and it is crucial for the efficient allocation of capital to productive investments. As growth contributes to poverty reduction, at least in absolute terms, the financial sector therefore facilitates and contributes indirectly to poverty alleviation.

In addition, the financial sector is essential for making economic growth pro-poor. Indeed, growth is not always pro-poor and in order for poor men and women to benefit from economic growth, the poor need to have access to markets and thereby be able to take advantage of opportunities. As highlighted in "Accelerating Pro-Poor Growth through Support for Private Sector Development", market outcomes are influenced by policies and institutions in five main areas: providing incentives for entrepreneurship and investment, increasing productivity, harnessing international linkages, improving market access and functioning and reducing risk and vulnerability. In each of these areas, the financial sector plays an important role:

i) ***Providing incentives for entrepreneurship and investment:*** access to financial services ensures that entrepreneurs have the facilities with which to do business and provides credit to allow them to make productive investments (in new technology, for example); monetary and fiscal discipline is also important for providing stability and reducing risks for vulnerable people and small businesses.

ii) ***Increasing productivity through competition and innovation.*** Investments in equipment, technology or education need to be financed and are key to increasing the productivity of individuals as well as of enterprises.

iii) ***Harnessing international linkages*** to take advantage of trade liberalisation and private capital flows. Dynamic trade flows require a proper payment system as well as trade financing mechanisms. The financial sector should provide safe, cost-effective and transparent formal channels for money transfers, including remittances. Moreover, a stable financial system is important for securing FDI as well as portfolio flows.

iv) ***Improving market access and functioning.*** Financial markets are one of the markets for which access is vital for the poor. By enabling the poor to draw down accumulated savings and/or to borrow to invest in income-enhancing assets (including human assets *e.g.* through health and education) and to start micro-enterprises, wider access to financial services generates employment, increases incomes and reduces poverty. Deepening the financial sector also gives more opportunities to the poor to have access to capital markets.

v) ***Reducing risk and vulnerability.*** Financial sector policy is crucial for macroeconomic stability, in order to avoid collective bank failure, inflation or currency crises. The development of insurance services, including those serving the poor, can also mitigate risks. By enabling the poor to save in a secure place, the provision of bank accounts (or other savings facilities) and insurance allows them to establish a buffer against shocks, thus reducing vulnerability and minimising the need for other coping strategies such as asset sales that may damage long-term income prospects.

What do we know so far?

The links between financial sector development, growth and poverty reduction

Despite measurement and definitional problems, most research has found evidence of a correlation between financial sector development, growth and poverty reduction.[2] It is legitimate to infer that, while there is a circular causation mechanism between financial sector development and growth, in developing countries the impact of financial sector development on growth is more important than the reverse. There is evidence that the less developed an economy the stronger the impact of the financial sector on economic growth.

In particular, it has been highlighted that a country with a high level of education cannot reap the full benefits of this unless the financial sector is reasonably well developed. It is also clear that the underdevelopment of the financial sector has a negative impact on growth. Some research goes as far as identifying a poverty trap, meaning that a weak financial sector limits the number of market players and creates a vicious circle, as low market development leads to low growth and to an even weaker financial sector.

Development of the financial sector has also been shown to have positive effects on poverty reduction, although it is difficult to split out the direct effect of access to financial services on poverty from the indirect effect via overall economic growth, partly because of a lack of data.

Microfinance institutions

At the micro level, there is also evidence of the positive effect of providing the poor with access to the financial sector through microfinance institutions (MFI), when they are properly managed.[3] The positive role of MFIs in poverty reduction is well established and documented, even though this sector encompasses a wide variety of institutions, with differences in the quality of management and efficiency.

Deficiencies in financial sectors in developing countries

Despite improvements in the last decade, the financial systems of developing countries still suffer from shortcomings and market inefficiencies that have an impact at various levels of the business environment.

Financial systems are fragile

Whatever the immediate macroeconomic and financial policy errors (exchange rate policy, for example), the 1997-98 financial crisis in Asia highlighted some fundamental flaws in developing country financial sectors. These flaws are linked to: *i)* problems caused by governments interfering in the allocation of resources through credit controls and regulated interest rates; *ii)* the lack of regulatory, accounting and operating procedures that comply with international standards, coupled with poor quality and opaque supervision and a lack of transparency; and *iii)* the almost systematic reliance on short-term foreign funding because local debt and equity markets are insufficiently developed.

Since the financial crisis of the last decade, the international community and governments have become aware of the necessity of achieving financial stability and transparency to avoid systemic risks and have been working continuously in this direction.

Financial systems are incomplete

First and foremost, formal financial systems in developing countries are incomplete and deficient. The majority of people do not have access to basic formal financial services. It is estimated that the proportion of people without a bank account reaches 90% in some African countries.

The weakness of the formal financial sector is a severe handicap for developing countries. Capital and money markets are still under-developed. Very few developing countries enjoy the macroeconomic stability needed to create even medium-term, let alone long-term, debt markets. They do not have government securities that can provide the reference values needed to establish an interest rate curve and few investors are willing to invest beyond a one or two-year time horizon, most of them fearing that the large-scale macroeconomic fluctuations to which these markets are exposed will compromise returns on investments.

There is little competition in the financial sector, which is often dominated by a handful of foreign banks, a few residual state-owned banks and under-capitalised local banks that operate in a segmented market. It is easier to create a vigorous financial market when there is genuine competition.

Lending to the private sector is insufficient. There is a lack of medium and long-term lending and a lack of instruments and institutions adapted to business needs, while the cost of credit is often too high for want of competition.

This situation is partly the result of deficient legal and regulatory frameworks that do not ensure a favourable business environment. Arbitration procedures and court decisions are too slow and open to influence and do not provide enough certainty, especially as regards debt collection (difficulty in realising mortgage guarantees, weak property rights). Banking regulations are ill suited to medium and long-term credit, which is often treated in the same way as short-term lending. Rules on contingency provisions are too strict for small-scale transactions (acknowledgement of mortgages only, which are expensive to register) and microfinance institutions do not always have a specific regulatory status.

What is controversial – supporting the enabling environment or direct interventions: Exclusive or complementary practices?

The case against direct intervention

Direct intervention, *i.e.* direct financial support to enterprises, banks or MFIs, in the past has often produced disappointing outcomes and some donors tend to advise against it, giving higher priority to actions related to improving enabling environments and institutions.

Direct intervention may result in market distortion and crowding out of the private sector through unfair competition. Such distortions could lead to misallocation of resources, thus reducing growth. There is a risk, for instance, that donor funds provided to an individual bank would give it an unfair advantage and prevent market forces from selecting the best competitor.

Donor funds may be better used to help build an enabling environment for the development and the deepening of the financial sector as a whole; in other words, direct support could be a sub-optimal use of donors' funds.

There is a risk that direct intervention might not bring about sustainable financial sector development, meaning that the services or the financing provided may disappear when donor support is no longer available.

Even if they are efficient, the impact of direct interventions depends on other factors such as the existence of an enabling environment. A study[4] shows that credit guarantee schemes can be effective in promoting sustainable changes in lender behaviour, leading to financial sector deepening, but only in situations where specific factors for success exist. These factors include the existence of an open, competitive banking environment, a dynamic and/or expanding business sector and a policy environment in which initiatives are co-ordinated and other government or donor initiatives do not crowd out market-driven initiatives, in particular through the provision of subsidised credit or other financial products and services. In such scenarios, guarantee schemes have the potential to play a role of accelerator rather than driver in deepening the financial sector.[5]

The case for direct intervention

While recognising the importance of the enabling environment and institutions, some donors consider that direct intervention is still beneficial, provided precautions are taken to avoid market distortion. There are a number of contexts in which direct intervention remains justified:

i) The recourse to public-private partnerships (PPPs) can lead to donors and development financial institutions (DFIs) directly participating in financing an activity or in a guarantee structure for it. PPPs are especially needed to finance infrastructure, including water or power distribution projects that are essential for increasing services for the poor. In these cases, donors' and DFIs' roles, as catalysts to attract private financing, are key. It is a good way to maximise the leverage of ODA.

ii) Appropriate interventions of donors on the market may open new channels, help develop new activities or create new instruments. For instance, providing guarantees to a special purpose vehicle issuing bonds on a local market may be a useful way of directing under-used savings towards investments and of avoiding foreign exchange risk thanks to the provision of loans in local currencies. Concessional credit lines to banks where the use of the grant is strictly limited to a specific development objective can have a strong demonstration effect.

iii) Changes in institutions or in regulation take time and while they are a necessary condition for developing the market they are not sufficient. For instance, in fragile states or in post-crisis situations, donors' direct interventions can have a powerful leverage effect on financial flows and provide an appropriate response to the emergency and the high level of risk in such situations. In less urgent cases, even if interest rates are liberalised and banks can legally extend medium or long-term loans, they are not ready to do it, due to lack of expertise, insufficient information or aversion to risk. Financial engineering introduced and supported by donors can address this, by promoting instruments such as guarantees, credit enhancements and specific financial vehicles. Microfinance is a good case in point: even in developed countries with a sophisticated financial sector, the poor have difficulty accessing financial services. All the more so in developing countries; a good competitive banking system does not guarantee that the needs of the poor will be addressed. In such countries, direct donor intervention has allowed microfinance institutions to grow, which in certain cases has attracted banks into this activity.

Best practices

When designing priorities for support, donors should consider the type of financial sector in which they intervene. In countries with less developed financial sectors, a pro-active approach should be applied. Priority should be given to assistance geared towards creating an "enabling environment": support for the regulation, supervision and promotion of financial systems. In more sophisticated economies, donors should be pro-active and support policies and projects that extend the provision of financial services to the poor. These types of approaches are complementary and not exclusive but some attention should be paid to the sequencing of donor support.

When contributing to the creation, development or strengthening of the legal and regulatory environment, which is essential, donors should closely co-ordinate their actions at a macro-level, making sure there is no overlap or contradiction between approaches.

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However, when donors extend support to financial intermediaries, different views and practices can foster innovation, provided that some basic principles are respected, especially the avoidance of market distortion.

When conditions are met for donors to play a catalytic role in building public-private partnerships by using public funding, they could consider blending concessional and non-concessional resources, setting strict rules concerning the use of concessional funding. The decision on whether to offer concessional funding should be independent of the nature (public/private) of the intermediary, but when the intermediary is a private entity great care should be taken so as to avoid market distortion. It means in particular that the concessional resources should be allocated in a transparent way to deserving beneficiaries or uses such as: *i)* investments aimed at strengthening the sector's environment; *ii)* providing services for poor people who do not have easy access to private services; *iii)* supporting public borrowers who implicitly play a balancing role between social action and profitable business; or *iv)* investments with a strong environmental and/or social impact. Finally, donors should only use concessional funding during pilot stages and seek to build sustainable solutions that will exist after their withdrawal.

Donors should aim for sustainable, long-term impacts from their interventions when providing financial support for small and medium-sized enterprises (SMEs). Therefore, if they provide credit lines or guarantees to financial intermediaries, it is particularly important that they cover only a portion of the risk and make sure that a significant part is borne by the lender. If such precautions are taken, this type of assistance can have a demonstration effect and help financial intermediaries to learn how to manage the risk of lending to SMEs. It can also help to build expertise and reduce information asymmetries by giving the lending institutions the opportunity to gather information on SMEs' credit worthiness.

When refinancing microfinance institutions, donors should avoid subsidies, except in some instances such as capacity development, and use subordinated debt instruments in local currencies. Subsidies, which may have been necessary at the beginning of microfinance, are not the right tool when it comes to mature institutions that are already sustainable and only need help to grow. Indeed, the donor's role has evolved with the development of microfinance, and donors should now aim to consolidate existing microfinance institutions and strengthen their financial and institutional viability.

Policy implications and suggestions for donors

Information on financial sectors in developing countries

Designing strategies for financial sector development, and connecting the poor to this sector, requires a better understanding of initial conditions and constraints. Therefore, in order to increase the focus on the issue of access, there is a need for more information on levels of access to financial services, barriers to widening access, scale and the nature of unmet demand. Donors and DFIs should encourage the collection of such data by financial institutions or through household surveys on access to financial services.

Business environment

The development, strengthening and consolidation of the institutional and legal environment is of particular importance in broadening and deepening the financial sector. The main aim of donors' interventions should be to make sure that the authorities have the willingness and all the necessary tools to develop the financial sector. They should also be encouraged to remain focused on the objective of enhancing access to financial services, including in financial sector assessments such as the Financial Sector Assessment Program (FSAP) run jointly by the World Bank and the International Monetary Fund (IMF). In this respect it is mainly the responsibility of multilateral organisations to act, for instance the IMF when it comes to monetary, financial or fiscal policies, but bilateral donors also have a role to play. They could in particular encourage the professionalisation of supervisory authorities and market regulators. They could also support the development of financial infrastructure, for instance helping to set up credit bureaux and asset registries.

It is also necessary, in order to improve the quality and the transparency of the financial sector, to help developing countries to implement international financial standards and codes; this concerns in particular corporate governance, international accounting and auditing systems.

Financial intermediaries

Strong financial intermediaries will lead to better resources allocation. As part of a long-term strategy to make financial markets respond better to the needs and constraints of the poor, there may be a need for donors to provide support to financial intermediaries such as banks, insurance companies, institutions specialised in refinancing local authorities, and microfinance institutions. Modernisation of payment systems is also an important issue: in particular the spread of electronic money and the transfer of remittances. Donors could also consider interventions that help intermediaries that operate in sectors where returns are low or deferred, for example, education, healthcare, housing, small business, farming and refinancing.

Financial engineering

Financial instruments are needed to devise innovative and well-adapted solutions, while increasing the leverage of donors' funds. This is of particular interest for the financing of investment in pro-poor infrastructure, such as water or power distribution. But it can also be of value in other instances. For example, a bank may have a portfolio with a lower risk rating than that of the bank itself; in such a case donors could help the bank to raise money through a securitisation transaction. New resources could then be tapped on more favourable terms and via the local market. It is worth promoting instruments such as guarantees, credit enhancement, specific financial vehicles and public-private partnerships as ways of increasing the leverage of public sector resources on private sector ones. In this regard, donors who can draw on the requisite specialist expertise could play the role of a catalyst: they can help structure specific financing schemes to attract other investors (foreign or local) and they bring expertise, help to create new instruments and contribute in this way to the broadening of the financial sector.

Savings mobilisation

One important donor policy orientation should consist of supporting increased mobilisation of savings. This will allow the use of domestic resources available for investment as a whole, as well as helping the poor to accumulate more savings on a secured basis. To this end, donors can help to structure and develop financial markets by supporting specialised financial intermediaries and institutional investors (*e.g.* collective savings management instruments, life and pension insurance, pension funds).

Remittances

Migrants contribute in an important way to the informal and formal financial sectors in their country of origin. The whole system (banking, savings, and credits) needs to be adapted to allow them to contribute to the fight against poverty. A significant proportion of immigrants in host countries as well as their families in home countries remain "unbanked". Therefore, one of the major challenges confronting traditional financial institutions and other financial service providers is to integrate unbanked senders and receivers into the financial system through better outreach, new technologies and more cost-efficient and transparent services.

CGAP principles

The Consultative Group to Assist the Poor (CGAP) have developed a set of Key Principles of Microfinance[6] that provide good practices for the sound development of microfinance and which most donors follow. Under these principles, three important orientations should be given particular attention. The first is the promotion of a favourable legal and institutional environment. In this respect, it is important to support the efforts of national and regional monetary authorities to develop appropriate legal and regulatory frameworks for microfinance. Second, donors should help to consolidate existing financially viable microfinance institutions with the aim of helping them to attain a critical mass and to increase their number of beneficiaries. Third, it is advisable to promote linkages between microfinance institutions and banks to capitalise on their synergies and draw on the different skills and capabilities of each.[7]

PRSPs and financial sector policies

Notwithstanding the general recognition that the development of the financial sector is important for growth and poverty alleviation, the coverage of financial sector policies in Poverty Reduction Strategy Papers (PRSPs) is very uneven and a number of PRSPs cover financial sector issues only marginally or even not at all. This calls for additional dialogue between donors and partner countries in order to raise awareness and identify objectives at the policy level.

Conclusions

In addition to the more traditional focus of financial sector policy makers and regulators on efficiency and stability, it is important to realise that the financial sector plays a central role in enabling the poor to participate in and take advantage of economic growth. This paper highlights the importance of focusing on ways to promote wider access to financial services for the poor. In doing so, donors will help to open up the financial sector by the provision of new funding mechanisms and the encouragement of new financial activities.

In designing such strategies, donors should consider the following priorities:

i) Encourage the collection of data on levels of access to financial services, barriers to widening access and the scale and nature of unmet demand.

ii) Encourage greater professionalism in supervisory authorities and market regulators and help with the implementation of international financial standards and codes.

iii) Strengthen financial intermediaries and help them to find sound instruments to serve sectors where returns are low or deferred.

iv) Play a catalytic role by structuring specific financing schemes to attract other investors or by bringing expertise, helping in the creation of new instruments.

v) Support an increased mobilisation and prudent intermediation of savings.

vi) Bridge the gap between microfinance institutions and the formal banking system.

vii) Encourage partner countries to cover financial sector issues in PRSP documents.

Notes

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2. For instance: Beck *et al.* (2004), "Finance, inequality, and poverty : cross-country evidence", World Bank Policy, Research Paper No. WPS3338, 2004; "The importance of financial sector development for growth and poverty reduction", DFID, August 2004.
3. AFD (French Development Agency) (2005), "Microfinance", in Parole d'Acteurs (Key players' views), No. 4.
4. DFID (2005), *Do credit guarantees lead to improved access to financial services?,* London.
5. A related controversial issue pertains to the treatment of guarantees in ODA accounting. Guarantees are counted as ODA only when the risk occurs (such as in the event of default), and when the guarantee is called. Considering the role of guarantees, at least as an accelerator of financial sector deepening, and more generally to leverage private local and foreign capital to finance private investment in developing countries, this accounting system underestimates the role of guarantees as a development instrument. It even may have a disincentive effect on donors in the present context of increasing ODA flows. Several DAC members have proposed changing how guarantees are recorded in DAC statistics but there is no consensus to modify the current system.
6. CGAP (Consultative Group to Assist the Poor) and World Bank (December, 2004), *Building Inclusive Financial Systems: Donors Guideline on Good Practice in Microfinance.*
7. CGAP (September 2004), "Breaking Down the Walls between Microfinance and the Formal Financial System", *Finance and Development*, No. 41, No. 2, Littlefield and Rosenberg.

Further reading

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Foreword

Promoting pro-poor growth – enabling a pace and pattern of growth that enhances the ability of poor women and men to participate in, contribute to and benefit from growth – will be critical in achieving a sustainable trajectory out of poverty and meeting the Millennium Development Goals, especially the target of halving the proportion of people living on less than one dollar a day. Developing and sharing good practice in advancing this agenda has been the focus of the Development Assistance Committee (DAC) through its Network on Poverty Reduction (POVNET) since 2003.

The DAC Guidelines on *Poverty Reduction*, published in 2001, show that poverty has multiple and interlinked causes and dimensions: economic, human, political, socio-cultural, protective/security. The work of POVNET since then has given priority to addressing strategies and policies in areas that contribute to pro-poor economic growth, with particular attention to private sector development, agriculture and infrastructure. POVNET has sought to build consensus on the key underpinnings of pro-poor growth and to explore recent thinking on risk and vulnerability and ex ante poverty impact assessment.

This compendium summarises the conclusions and recommendations coming out of POVNET's work on growth and poverty reduction. The key messages are as follows:

- Rapid and sustained poverty reduction requires pro-poor growth, as described above.
- Policies to tackle the multiple dimensions of poverty, including the cross-cutting dimensions of gender and environment, are mutually reinforcing and should go hand-in-hand.
- Empowering the poor is essential for bringing about the policies and investments needed to promote pro-poor growth and address the multiple dimensions of poverty.

For donors, the pro-poor growth agenda is not business as usual and more of the same will not be sufficient. This compendium provides specific guidance to donors on how to make their support to pro-poor growth more effective in the areas of private sector development, agriculture and infrastructure.

Richard Manning
DAC Chair

James T. Smith
POVNET Chair

In order to achieve its aims the OECD has set up a number of specialised committees. One of these is the ***Development Assistance Committee****, whose members have agreed to secure an expansion of aggregate volume of resources made available to developing countries and to improve their effectiveness. To this end, members periodically review together both the amount and the nature of their contributions to aid programmes, bilateral and multilateral, and consult each other on all other relevant aspects of their development assistance policies.*

The members of the Development Assistance Committee are Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, the United Kingdom, the United States and the Commission of the European Communities.

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Acronyms

ACP	Africa, Caribbean and Pacific countries
ADB	Asian Development Bank
AdI*	*Aguas del Illimani*
AFD*	French Development Agency – *Agence Française de Développement*
AKFED	Aga Khan Fund for Economic Development
AU	Africa Union
BDS	Business development service
BLT	Build-lease-transfer
BMZ*	German Ministry for Economic Co-operation and Development *Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung*
BOT	Build-operate-transfer
BOOT	Build-own-operate-transfer
CAADP	Comprehensive African Agriculture Development Programme
CARICOM	Carribbean Community
CEDAW	Convention of the Elimination of All Forms of Discrimination against Women
CEPA*	*Comision Ejecutiva Portuaria Autonoma*
CGAP	Consultative Group to Assist the Poor
CIDA	Canadian International Development Agency
COMESA	Common Market for Eastern and Southern Africa
CSO	Civil society organisation
CUTS	Consumer Unity and Trust Society
DAC	Development Assistance Committee
DCI	Development Cooperation Ireland
DFI	Development financial institution
DTF	Devolution Trust Fund
DFID	UK Department for International Development
EPA	Economic Partnership Agreement
FAO	Food and Agriculture Organization of the United Nations
FDI	Foreign direct investment
FSAP	Financial Sector Assessment Program
GDP	Gross Domestic Product
GIC	Growth incidence curve
GTZ*	German Agency for Technical Co-operation *Deutsche Gesellschaft für Technische Zusammenarbeit GmbH*
ICN	International Competition Network
ICT	Information and communication technology
IDA	International Development Association
IFAD	International Fund for Agricultural Development

IFC	International Finance Corporation
IGE	Intergovernmental Group of Experts on Competition Law and Policy
IICA	Inter-American Institute for Cooperation on Agriculture
IMF	International Monetary Fund
IT	Information Technology
IWRM	Integrated water resource management
JBIC	Japan Bank for International Cooperation
JICA	Japan International Cooperation Agency
KfW*	German Bank for Development – *Kreditanstalt für Wiederaufbau*
MDG	Millennium Development Goal
MERCOSUR*	*Mercado Común del Sur*
MFI	Microfinance institution
MTEF	Medium-term expenditure framework
SME	Medium, small-sized enterprise
MSME	Micro, small and medium-sized enterprise
NEPAD	New Partnership for Africa's Development
NGO	Non-governmental organisation
NORAD*	Norwegian Agency for Development Co-operation
ODA	Official development assistance
OECD	Organisation for Economic Co-operation and Development
PIA	Poverty Impact Assessment
PIDG	Private Infrastructure Development Group
PIP	Public investment programme
POVNET	DAC Network on Poverty Reduction
PPD	Public-private dialogue
PPP	Public private-sector partnership
PRS	Poverty reduction strategy
PRSP	Poverty reduction strategy paper
PSD	Private Sector Development
PSIA	Poverty and Social Impact Analysis
PSO	Private sector organisation
RADEEF*	*Régie Autonome de Distribution et d'Électricité de Fès*
REDI	Recent Economic Developments in Infrastructure
Seco*	Swiss State Secretariat for Economic Affairs
Sida*	Swedish International Development Cooperation Agency
SME	Small and medium-sized enterprises
SWAp	Sector-wide approach
TAF	Local Capacity Building Technical Assistance Facility
UEMOA*	West African Economic and Monetary Union *Union Économique et Monétaire Ouest Africaine*
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
USAID	United States Agency for International Development
WTO	World Trade Organization
WFP	World Food Programme

* Denotes acronym in original language.

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Pro-poor Growth: Policy Statement

The 2001 DAC Guidelines on *Poverty Reduction* show that poverty has multiple and interlinked causes and dimensions: economic, human, political, socio-cultural, protective/ security. This policy statement focuses on one dimension of that bigger picture – reducing economic poverty through pro-poor growth. In doing so, it looks at the relationship between the economic and other dimensions of poverty and how policies for pro-poor growth and other policy areas need to interact so that, collectively, they can make major and sustainable inroads into poverty reduction.

Three key messages from this work are that:

- Rapid and sustained poverty reduction requires pro-poor growth, *i.e.* a pace and pattern of growth that enhances the ability of poor women and men to participate in, contribute to and benefit from growth. Policies therefore need to promote both the pace of economic growth and its pattern, *i.e.* the extent to which the poor participate in growth as both agents and beneficiaries, as these are interlinked and both are critical for long-term growth and sustained poverty reduction.
- Policies to tackle the multiple dimensions of poverty, including the cross-cutting dimensions of gender and environment, are mutually reinforcing and should go hand-in-hand. Progress in one dimension will be accelerated by progress in others. In tackling poverty, perceptions of policy dichotomies have been misplaced. Policy trade-offs do exist but can be better managed.
- Empowering the poor is essential for bringing about the policies and investments needed to promote pro-poor growth and address the multiple dimensions of poverty. To achieve this, the state and its policy making processes need to be open, transparent and accountable to the interests of the poor. Policies and resources need to help expand the economic activities of the poor.

When implementing the policy guidance on how donors can support and facilitate pro-poor growth, they must bear in mind that the poor are not a homogenous group, that country contexts vary considerably, and that policy implementation must be based on a sound understanding of who the poor are and how they earn their livelihoods. Promoting pro-poor growth requires policy choices to be guided by assessments of their expected impact on the income and assets of the poor.

Rapid and sustained poverty reduction requires pro-poor growth, i.e. a pace and pattern of growth that enhances the ability of poor women and men to participate in, contribute to and benefit from growth.

i) **Both the pace and the pattern of growth are critical for long-term and sustainable poverty reduction.** Economic growth is an essential requirement and, frequently, the major contributing factor in reducing economic poverty. For growth to be rapid and sustained, it should be broad-based across sectors and regions and inclusive of the large part of the workforce that poor women and men make up. Pattern and pace are thus interlinked and need to be addressed together. Policies for sustaining growth such as those aiming at macroeconomic stability, institutional quality, democratic and effective governance and a favourable investment climate should promote the engagement of the poor in economic growth by increasing their incentives, opportunities and capabilities for employment and entrepreneurship.

ii) **A pro-poor pattern of growth makes growth more effective in reducing poverty.** Developing countries with similar rates of economic growth have experienced quite different levels of economic poverty reduction, due to initial conditions and whether growth occurs in areas and sectors where the poor live and are economically active. Policies need to create the conditions and remove the obstacles to the participation of the poor in the growth process, *e.g.* by increasing access to land, labour and capital markets and by investing in basic social services, social protection and infrastructure. As the poor often depend heavily on natural resources for their livelihoods, policies to promote environmental sustainability should also be integral to promoting pro-poor growth.

iii) **Inequality matters.** Inequality of assets and opportunity hinders the ability of poor people to participate in and contribute to growth. High and rising levels of income inequality lower the poverty reduction impact of a given rate of growth and can reduce the political stability and social cohesion needed for sustainable growth. Gender is a particularly important dimension of inequality. Women face particular barriers concerning assets, access and participation in the growth process, with serious implications for the ability of growth to be pro-poor. The growth experience shows that rising inequality is not an inevitable consequence of the growth process, as long as there is a mix of policies that addresses both growth and distributional objectives, strengthens empowerment and deals with gender and other biases (*e.g.* race, caste, disability, religion).

iv) **The vulnerability of the poor to risk and the lack of social protection reduce the pace of growth and the extent to which it is pro-poor.** The poor often avoid higher risk opportunities with potentially higher payoffs because of their vulnerability. In addition, the journey out of poverty is not one way and many return to it because man-made and natural shocks erode the very assets that the poor need to escape poverty. Policies that tackle risk and vulnerability, through prevention, mitigation and coping strategies, improve both the pattern and pace of growth and can be a cost effective investment in pro-poor growth.

v) **Policies need to tackle the causes of market failure and improve market access.** Well functioning markets are important for pro-poor growth. Market failure hurts the poor disproportionately and the poor may be disadvantaged by the terms on which they participate in markets. Programmes are needed to ensure that markets that matter for their livelihoods work better for the poor. Such programmes need to be carefully designed to avoid replacing market failure with government failure. Policies to tackle market failure should be accompanied by measures aimed at increasing economic capabilities of the poor.

In tackling poverty, perceptions of policy dichotomies have been misplaced. Policy trade-offs do exist but can be better managed.

i) **Policies to tackle the multiple dimensions of poverty should go hand-in-hand**. Poverty is multidimensional. Pro-poor growth will be strengthened by progress on the non-economic dimensions of poverty. More effective policies require a better understanding of these interdependencies. Perceptions of dichotomies (*e.g.* economic *versus* social policies) can be misplaced. The pace and pattern of growth have multiple determinants and consequences and each dimension nourishes (or holds back) the other. Progress on the income poverty Millennium Development Goal (MDG) facilitates progress on other MDGs and *vice versa*.

ii) **Policy trade-offs still exist, but can be better managed.** Policies which promote only one dimension of poverty reduction while undermining others should be avoided. Whenever possible, policies need to be complementary rather than compensatory. Sequencing of policies and investments can help manage trade-offs. Policy choices should be based on understanding the binding constraints through analysis of the growth, poverty and inequality experience and the results of poverty impact assessments. The ability of institutions to handle trade-offs is important for achieving pro-poor outcomes.

For pro-poor growth policies to emerge, the poor need to be informed and empowered to participate in a policy-making process that is accountable to their interests.

i) **The poor need to participate in and influence the policy reform process that goes with poverty reduction strategies (PRSs).** Approaches are needed to increase the voice and influence of poor women and men in order that policy making is evidence-based, rather than determined by narrow vested interests.

ii) **A well-functioning state is important for responding to the interests of the poor**. Effective pro-poor growth strategies need policy and institutional change for which the state, in all its dimensions, is made more accountable to the interests of the poor. The state needs to provide the opportunity for structured public-private dialogue at various levels, including with civil society and private sector actors who are frequently marginalised. The state needs to provide the required incentives, enabling environments and policy and planning frameworks to be more accountable to the voices of the poor.

iii) **Pro-poor reform is likely to require changes to the current political settlement among the diverse interests of different segments of society.** This entails a better understanding of the political economy, power relations and drivers of change, and supporting formal, transparent decision making, strengthening the demand for pro-poor change and building capacity of the state to respond to demand.

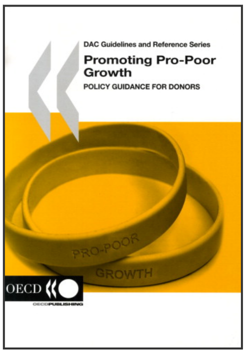
For donors, the pro-poor growth agenda is not business as usual and more of the same will not be sufficient.

i) **Donors should focus on supporting in-country policy processes.** Policies for pro-poor growth can only be achieved through country-level processes that are inclusive of the poor and based on country-level analyses. Donors should support the emergence and development of processes that are formal, transparent and take account of the interests of the poor, and conduct their policy dialogue through them. Donors should support measures to empower the poor in these policy processes and build the country-level capacity to undertake analyses, including poverty impact assessments.

ii) **Donor support needs to be flexible and responsive to country situations**. The type of support provided needs to take account of the level of development, the policy environment and the extent to which there is a well-functioning state. Donors need to adapt their approach to fragile and failed states and more research is required to inform this process.

iii) **A pro-poor lens on areas important for pro-poor growth, such as private sector development, agriculture, infrastructure and risk and vulnerability, requires a rethinking of donor agendas.** The importance of these areas for the pace and pattern of growth has been underestimated. New approaches to strengthen the contributions of private sector development, agriculture and infrastructure have been developed by the DAC. Work on risk and vulnerability/social protection/human security is ongoing.

iv) **Donors need to enhance their organisational capacities to effectively support country-led, pro-poor growth.** Donors need to provide appropriate support and incentives to field staff, build multi-donor and multidisciplinary teams at the field level, and empower them to negotiate, co-ordinate and implement programmes. Recent progress to establish such teams in several partner countries should be replicated.



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