Interest Bearing Notes **Vol. 19 No. 3**

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The next issue of Interest Bearing Notes will appear in July 2016 so please send comments, suggestions (such as your own or others' interesting research), and requests to be added to our distribution list, to Paulina Sintim-Aboagye (mailto:psintimaboagye@worldbank.org) by July 8th.

IBN is a product of the Finance and Private Sector Development Team in the World Bank's Development Research Group. Our working papers and descriptions of research projects in progress can be found, along with a list of forthcoming seminars and conferences, on our web page (http://www.worldbank.org/en/research/brief/finance-private-sector).

I What's new on our website

Financial inclusion and the Sustainable Development Goals
In 2015 the UN General assembly adopted the 2030 Agenda for Sustainable Development, and with it, a set of 17 sustainable development goals (SDGs). In a new CGAP working paper, our own **Leora Klapper** and **Jake Hess**, together with **Mayadi El-Zoghbi** synthesize recent research to explore how financial inclusion can help in achieving the SDGs. While the authors are quick to admit that the research on financial inclusion does not yet speak to all of the SDGs (see, for example, climate action), they argue that the literature does have a direct bearing on achieving goals in health, education, and gender equality and that financial inclusion can play an important indirect role in achieving goals related to broader inequality, growth, and even peace.
http://www.cgap.org/sites/default/files/Working-Paper-Achieving-Sustainable-Development-

Goals-Apr-2016.pdf

II World Bank research

Can business owners form accurate counterfactuals?

Our own **David McKenzie** assesses the extent to which business owners can form accurate counterfactuals about what would have happened to their business had an alternative investment process taken place. He does this in the context of a large business plan competition carried out in Nigeria, where the winners received an average of US$50,000 each as business grants. An experimental evaluation of this program undertaken in an earlier paper by David showed that winning this competition resulted in large increases in business start-up, survival, employment growth, and sales growth. For the new paper, winners in the treatment group were asked subjective expectations questions about what would have happened to their business should they have lost, while non-winners in the control group were asked similar questions about what would have happened should they have won. Assessing the accuracy of these expectations is useful for example from a program evaluation standpoint where it is often difficult to estimate a valid counterfactual. If applicants are able to form accurate estimates of their counterfactuals under the alternative treatment status, this would provide a means of estimating program impacts even for programs in which no suitable control group can be found. David's results show that firms do not provide accurate counterfactuals. Both the control and treatment groups systematically overestimate how important winning the program would be for firm growth: the control group thinks they would grow more had they won than the treatment group actually grew, while the treatment group thinks they would grow less had they lost than the control group actually grew. This systematic bias towards thinking programs will help suggests that the use of elicited counterfactuals is unlikely to be a good substitute for alternative forms of impact evaluation, at least in settings that involve dynamic outcomes, such as business start-up and growth.
http://documents.worldbank.org/curated/en/2016/05/26363171/can-business-owners-form-accurate-counterfactuals-eliciting-treatment-control-beliefs-outcomes-alternative-treatment-status

Finding a path to formalization of micro and small firms in Benin

In April 2014, the Government of Benin launched the entreprenant status, a simplified legal regime offered to small informal businesses to enter the formal economy. A new paper by **Najy Benhassine**, our own **David McKenzie**, **Victor Pouliquen**, and **Massimiliano Santini** presents the short-term results of a randomized control trial testing the effect of three different versions of the entreprenant status on business registration decisions. During the trial, 3,600 informal businesses operating in a fixed location were randomly allocated between three treatment groups and one control group, where each treatment included incremental incentives for business registration: (i) information on the new legal status and its benefits, (ii) business training, counseling services, and support to open a bank account, and (iii) tax mediation services. One year after the program launch, all treatments had a significant impact on formalization rates, measured through administrative data on business registration. The impact was 9.1 percentage points in the first treatment group; 13 percentage points in the second group; and 15.8 percentage points in the last group. The formalization rate in the control group was less than 1 percent, suggesting that in the absence of the program, informal businesses like the ones in the study would not formalize. At the same time, the measured effects show that at least 84 percent of

firms still remain informal even after receiving incentives to formalize. One reason for this finding is that lack of proper identification was a barrier: only 53% of business owners had a passport or an ID card, the official documents required to formalize. Data from a second follow-up survey, which is expected to take place this year, will explore the impacts on other outcomes, like business performance or access to banking services.
http://documents.worldbank.org/curated/en/2015/12/25660436/finding-path-formalization-benin-early-results-after-introduction-entreprenant-legal-status

Mission drift in microfinance
Do microfinance institutions (MFIs) drift from their mission to serve the poorest customers as they mature, and have tensions between pursuit of deep outreach and profitability become more pronounced as MFIs have increasingly relied on commercial sources of funding? Such 'mission drift' inherently involves changes in target markets over time, but short time series for a large set of MFIs are ill-suited to detect any such effects, given the wide variation across institutions in ownership structures, funding strategies, and lending methods. IBN co-editor **Bob Cull**, together with **Xiangping Xia**, **Pei Guo**, and **Tao Ma** use a unique new data set for loan officers of the largest Chinese MFI owned as a non-governmental organization (NGO) to explore these issues. The data span 2006 to 2010, a period in which the MFI shifted from reliance on subsidized sources of funding from the government (mainly donated equity) to commercial funding. The main findings are that profitability improved, loan sizes increased, and the share of loans carrying individual (rather than group) liability grew, all consistent with mission drift. However, loan officers who were formerly farmers or worked in local government were better able to maintain their lending to poorer borrowers (as reflected in smaller loan sizes), without incurring substantially lower loan repayment rates. It therefore appears that the career backgrounds of loan officers played an important role in reducing mission drift.
http://documents.worldbank.org/curated/en/2016/05/26396730/commercialization-mission-drift-evidence-large-chinese-microfinance-institution

A meta-analysis on the impact of business support services on firm performance
A new paper by **Tulio Cravo** and **Caio Piza** presents a meta-analysis based literature review on the impact of business support services for small and medium enterprises (SMEs) in developing countries. The authors include 40 rigorous evaluations of such services, focused solely on firms larger than those run by micro-entrepreneurs. This is an important review exercise and carries valuable policy relevance, since SMEs are responsible for the majority of employment and job creation activities in developing countries. The findings suggest that business support services targeted toward SMEs have on average positive impacts on business performance, employment, and labor productivity, though there is wide variance in impact across the studies covered in the review. The analysis also shows that matching grant schemes have positive impact on job creation and firm performance. The review paper concludes with a call for further rigorous research in this area to better understand the precise mechanisms behind these impacts, and in particular to understand how and for whom business interventions work best.
http://documents.worldbank.org/curated/en/2016/05/26360541/impact-business-support-services-small-medium-enterprises-firm-performance-low--middle-income-countries-meta-analysis

III "FYI": Our eclectic guide to recent research of interest

Recent developments in global banking

Stijn Claessens has written a handy, but also extensive overview of recent research on global banking. In summarizing recent data he notes that, yes, there was some retrenchment by foreign banks after the global financial crisis (GFC). But foreign banks' rate of exit from host markets remained more less the same as it was prior to the GFC. It was therefore the slower rate of entry into markets post-GFC that led to net reductions in foreign presence. And foreign banks accounted for 11 percent of global banking assets at the end of 2013, down only slightly from the peak of 13 percent in 2007. Those aggregate figures, moreover, mask wide variation across countries – the share of banking assets held by foreign banks declined in 59 host countries, but it actually increased in 45 others. Banks from emerging market and developing economies (EMDEs) represented about 60 percent of the new entries post-GFC, while banks from OECD countries were responsible for most of the exits from markets. Much of the new entry comes from banks with headquarters in countries located close to host markets, so banking sectors have become more regionalized as the presence of EMDEs banks has grown. Looking forward, Stijn speculates that the trend towards regionalization of international banking could make coordination on regulation, supervision, and bank failure resolution somewhat easier. At the same time, he emphasizes that pursuing the policy objectives that comprise the so-called "financial trilemma" – maintaining global financial stability, fostering cross-border financial integration, and preserving national authority to resolve troubled banks – will continue to impose difficult trade-offs on policy makers. But the choices they make should recognize the ongoing shifts in global banking documented in this review.
https://www.business.unsw.edu.au/About-Site/Schools-Site/banking-finance-site/Documents/Recent-Developments-in-Global-Banking.pdf

Foreign bank entry and entrepreneurship

Laura Alfaro, former IBN co-editor **Thorsten Beck**, and **Charles Calomiris** investigate the relationship between foreign bank presence and new business formation using data across 48 developing countries and 36 manufacturing industries. Empirical evidence on this topic has been scarce so far and theory is inconclusive. On the one hand, foreign bank entry may promote business formation by reducing the cost of credit since foreign banks can bring capital, technical skills, and product innovation to host countries, which increases competition and leads to improvements in the efficiency of the banking sector. On the other hand, fierce competition with foreign banks for funding or relationships could threaten the survival of local banks and thus lead to reduced access to finance, especially if foreign banks concentrate on the top and selected segments of the market. The authors use 2004 data from WorldBase compiled by Dun and Bradstreet to compute business formation rates at the country-industry level, defined as the share of businesses in the country-industry that are less than two years old. Their measure of foreign bank presence in a given country is the ratio of foreign banks' assets to total bank assets in 2003, as computed by Claessens and van Horen (2014). They interact this variable with industry characteristics, such as the need for external finance, as measured by Rajan and Zingales (1998). Results show that a larger share of foreign banks' assets in a country's banking system is associated with a higher rate of business formation in industries with an exogenously greater need for external finance. This relationship is especially strong for South-South bank presence, suggesting that these types of foreign banks may have a particularly large and beneficial impact on the financing costs of young firms.
http://www.nyudri.org/research-index/2015/foreignbank

Apprenticeship and growth in pre-industrial economies

Why did the Industrial Revolution happen in Western Europe rather than in China or India? In a new paper that combines economic history with theoretical modelling, **David de la Croix**, **Matthias Doepke** and **Joel Mokyr** suggest that variation in the historical institutions associated with apprenticeship help explain the speed of technological progress and growth rates across regions. In the pre-Industrial era in countries such as China and India, apprenticeship tended to be clan-based and thus apprentices could only absorb best practices within the extended family. Moreover, the masters within the clan tended to have a similar level of proficiency in a specific technique, again limiting the scope for technological progress in the clan-based system. In contrast, in Western European countries apprentices could follow masters within guilds (associations of artisans in the same profession). Since masters were spread across geographic areas, apprentices could adopt best practices from a much wider network. Similar to the current post-doc system in academics, journeymen also contributed to the level of skills development and technological progress in Western Europe. At an intermediate step between apprentices and masters, the journeyman continued to work with a master, enabling him to further improve his technique and to gain more learning-by-doing experience. In countries such as Britain and Holland, centralized governance through the court system emerged to resolve contractual issues associated with apprenticeship and also expanded the scope for innovation beyond the guilds, resulting in even higher levels of technological progress. In countries that were slower to adopt those changes, however, the guild system was still a far superior alternative to the clan-based system in generating technological progress and growth.
http://www.nber.org/papers/w22131.pdf

Social capital and the resilience of the financial system

A large literature emphasizes the importance of social capital for contract enforcement and economic performance, and a similarly voluminous literature examines the effects of financial access on economic performance. In a recent paper, **Chen Lin**, our former colleague **Ross Levine**, and **Wensi Xie** try to marry these two literatures. They provide evidence that in times of financial crisis, countries with better social capital, as measured by trust, are able to provide more trade credit to listed companies. In turn, these corporations are able to maintain a higher level of employment and profits. Their evidence is based on Worldscope panel data for about 3500 firms in 34 countries, which allows them to control for firm and yearly fixed effects. In extensive robustness checks, they control for potential interactions between the crisis and macro variables, for a slew of institutional variables, and for country-, country-industry-, and firm-specific growth rates. They also show that the underlying economic importance of the influence of social capital on the resilience of the financial system (i.e., in mitigating the effect of the crisis on access to finance, and on the level of profits and employment) is pronounced.
http://www.nber.org/papers/w22153.pdf

IV Upcoming events and miscellanea

Prolonged low interest rates and banks' margins

In an interesting new note, **Stijn Claessens**, **Nicholas Coleman**, and **Michael Donnelly** use cross-country evidence to document the links between the low interest rates that have been common since the global financial crisis and banks' net interest margins. Their findings suggest

that low interest rates could hamper banks' financial performance in some key advanced economies for some time to come.
http://www.federalreserve.gov/econresdata/notes/ifdp-notes/2016/low-for-long-interest-rates-and-net-interest-margins-of-banks-in-advanced-foreign-economies-20160411.html

Call for papers
As also mentioned in the March 2016 IBN, the **2016 Portsmouth-Fordham Conference on Banking and Finance** will take place September 24-25 at the University of Portsmouth, UK. The deadline to submit a manuscript or an extended abstract is approaching fast: June 15, 2016. For more information on topics, registration, and other details, see the conference website: http://portcbf2016.eventsadmin.com

Happy reading!

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