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Prices or Knowledge? What Drives Demand for Financial Services in Emerging Markets?

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ABSTRACT

Financial development is critical for growth, but its microdeterminants are not well understood. We test leading theories of low demand for financial services in emerging markets, combining novel survey evidence from Indonesia and India with a field experiment. We find a strong correlation between financial literacy and behavior. However, a financial education program has modest effects, increasing demand for bank accounts only for those with limited education or financial literacy. In contrast, small subsidies greatly increase demand. A follow-up survey confirms these findings, demonstrating that newly opened accounts remain open and in use 2 years after the intervention.

FINANCIAL DEVELOPMENT IS WIDELY recognized as an important determinant of economic growth, with a large literature examining the determinants of the supply of banking and financial intermediation services (Levine (2005)). Yet the determinants of the demand for financial services are much less well understood, particularly in emerging market countries.

An important feature of emerging markets is the size of the informal sector. Recent estimates place the size of the informal economy at 14% of GDP in China, 23% in Indonesia, and 24% in India, against 8% in the United States (Buehn and Schneider (2009)). In 76 emerging market countries, the average size of the informal sector is almost 36% of GDP.[1] Arguably, drawing these individuals and firms into the formal financial sector would be one of the fastest ways to foster financial development in emerging markets.

Two leading views may explain limited demand for formal financial services. First, because these services involve high fixed costs and hence are expensive to

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[1] Our baseline surveys find that 53% of the rural sample from India has savings in a nonbank institution while 64% borrow from informal sources. Similarly, nationally representative figures from Indonesia show that 51% of the population saves in nonbank institutions and 32% borrows informally; nearly 20% of households in Indonesia borrow and save exclusively in the informal sector.

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