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Financial Development and Poverty Alleviation in Muslim Developing Countries

***Maizura Md Isa [1], Nor Hazila Ismail [2] and Mohamed Eskandar Shah Mohd Rasid [3]**

[1] Lecturer, Faculty of Business and Administration,
Universiti Teknologi MARA (UiTM) Johor
85000 Segamat, Johor, Malaysia
maizu493@johor.uitm.edu.my

[2] Lecturer, Faculty of Business and Administration,
Universiti Teknologi MARA (UiTM) Johor
85000 Segamat, Johor, Malaysia
norha884@johor.uitm.edu.my

[3] Lecturer, International Centre for Education in Islamic Finance (INCEIF),
Lorong Universiti A, 59100 Kuala Lumpur
eskandar@inceif.org

Abstract

The positive impact of financial development on economic growth has been widely discussed, but the literature on the impact of financial development on poverty is inconclusive. Theoretical predictions advocate that financial development contributes directly to poverty reduction in three ways. Firstly, it alleviates poverty in a direct way via saving, insurance service and access to credit that can enhance the productivity of the poor. Secondly, financial development would enable the poor to access financial services, and enhance the productive assets of the poor, by improving productivity and increasing the potential to achieve sustainable gains. Lastly, the direct relationship between financial development and poverty reduction depends on the quality of financial instruments, services and institutions available to the poor. Varied explanantory discover on panel studies that suggest although financial development can foster economic growth, yet this does not could help in lighten the poorer people in Muslim developing countries.

Keywords: Financial developments, Poverty, Muslim Developing Countries.

1. Introduction

1.1 Background

Modernization and rising living standards notwithstanding, poverty[1] remains a major concern for the global economy. In 1990, almost half of the population in developing regions lived on less than $1.25 a day. This rate dropped to 22 per cent by 2010, reducing the number of people living in extreme poverty by 700 million. Yet despite this progress, the problem of poverty still exists, from the early 1990s to the late 2000s, 1.2 billion people lived in extreme poverty. There is a general consensus that addressing poverty eradication is an utmost challenge facing the world.

The multiple factors of poverty are illustrated in a series of case studies in *Voices of the Poor* by the World Bank, for instance highlighting the experiences of ill-being including material lack and want (food, housing and shelter, asset and money); hunger, pain and discomfort; exhaustion and poverty of time.Khadar, (2014)highlights that poverty is due to inadequate access to assets such as land and capital, overlooking the importance of rural areas in favour of urban areas, too little access to market, health and sanitation, and water services. The study also points out that the constant destruction of natural resource endowments and non-participation of the poor in the design of development programmes have also contributed to the poverty phenomenon. Thus, the impact not only on starvation but also limiting the access to good education, distancing the needy people from good career, leading to poor prospects for employment opportunities. Furthermore, poverty has come to be seen as the result of the deprivation of basic capabilities, which leads to reduced life expectancy, health, participation as well as the absence of real opportunities to lead a valuable and valued life (UNPD, 2000).

1.2 Financial Development and Poverty Alleviation

As discussed in many literatures, financial development effects economic growth and poverty tremendously, because growth is a powerful way to reduce poverty. However, it has been unclear wheter it also shrinks poverty. A model suggests that financial development enhances growth and reduces inequality. It can be done by (i) disproportionately relaxing credit constraints on the poor and reducing income inequality and (ii) improving the allocation of capital and increasing growth.

Theoretical predictions advocate that financial development contributes directly to poverty reduction in three ways. First, in a direct way via saving, insurance service and access to credit that can enhance the productivity of poor(Jalilian and Kirkpatrick , 2005).Secondly, financial system enables the poor to access financial services, especially credit and insurance risk, and it will enhance the productive assets of the poor, by improving productivity and increasing the potential to achieve sustainable gains (Jalilian and Kirkpatrick , 2001). Lastly, the direct relationship between financial development and

[1] World Bank (1990) defined poverty as the inability to attain a minimum standard of living. The condition where people's basic needs for food, clothing, and shelter are not being met. Poverty is a tireless problem throughout the world and has had adverse impacts on all aspects of family life.

poverty reduction depends on financial instruments, services and institution available for poor (Holden and Prokopenko, 2001)

Additionally, financial development may also affect the poor in two ways: by boosting economic growth (and making people richer) and by changing the distribution of income. A high economic growth rate, induced by financial development contributes automatically to poverty reduction ((Levine, 1999;Rajan and Zingales, 1998).In addition, Greenwood and Jovanovic, (1989)found that financial development indeed could benefit the poor depending on the level of economic development. Meanwhile, Beck *et al*, (2004), indicates that increase in financial development in a poor country induces the income of the poorest people in that nation to grow faster than the average per capita gross domestic product (GDP).

There are also dramatic differences in poverty among countries, even among developing countries. Park & Mercado, (2015) find that poverty and inequality remains a stubborn challenge in a developing Asian countries despite the region's rapid economic expansion in previous decades , which lifted millions out of poverty. Results of within-country studies are rather mixed, where the study by Giné and Townsend (2004) in Thailand find that financial development affects different group of population differently.

Despite financial development method been used in reducing poverty, yet the problem still exists. A study by (Janvry and Sadoulet(2000), find that income growth is effective in alleviating poverty and inequality if the level of inequality is not too high and if educational levels are sufficiently higher. Nevertheless, Greenwood and Jovanovich (1990), raised a serious concern whether financial development benefits the entire population. The study argues that at the early stage of development, only the rich manage to access and benefit from the financial market development. This, in turn, increases income inequality and may not necessary lowering the poverty rates. This intricate relationship raises the question whether the financial development helps in alleviating poverty or there is no guarantee that this growth drained by financial development benefits the poor, because sometimes a high growth does not always translate into poverty reduction. Thus the relationship between financial development and poverty is not conclusive. The precise impact has not well been defining in either empirical studies or the theoretical literature. The objective of this paper is to study whether developments in the banking sector and stock markets have contributed to a reduction in poverty.

In line with the global trends, OIC countries was also experienced significant movement in poverty situation. However, poverty remain comparatively very high in OIC countries where they were home to 1/3 (33.1%) of world total poor in 2011 (SEISRIC 2015). It has been reported about 35% people still live in multidimensional poverty in OIC countries. In developing countries of OIC, absolute poverty is still a greater concern (SEISRIC 2015). In addition, Duclos and Wodon (2004) also stated that in developing countries absolute poverty is a greater concern. The situation was getting far worse for the countries that come from sub-Saharan Africa. Many literatures shown that there has been a general reduction in extreme levels of poverty in developing countries across the globe, serious problem remain. These problems motivated us to focus on Muslim developing countries

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2. Literature Review

Poverty alleviation is a complex phenomenon and requires ongoing efforts by governments and international organizations. Since the United Nations Millennium Declaration and the subsequent agreement on the Millennium Development Goals (MDGs)[2], the international community has highlighted its commitment to the reduction of poverty and inequality.

Ismail Sirageldin (2000) had identified three main components or features of poverty, namely subsistence, inequality and externality. Subsistence relates to "minimum of provisions needed to maintain health and working capacity" (capabilities). Inequality is concerned with the "relative position of income groups to each other." Externality is associated with "social consequences of poverty for the rest of the society rather than in terms of the needs of the poor" of policies dealing with poverty. According to Lowen (2009), poverty can be divided into two types[3] — transitional poverty and intergenerational poverty.

From the economic perspective, poverty is classified into three categories. Absolute poverty (the income below a certain level necessary to maintain a minimum standard of living).Income inequality (how the benefits of the development are allocated among individuals in a group, among groups in a population, or among countries, and Relative poverty (instances where household income is less than the average income by a certain amount). For example, in the UK, relative poverty is defined as income 50% less than average incomes.[4]

The literature, where the focus is on the economic aspect of poverty, mainly uses four related indicators i) the headcount index; ii) the poverty gap which both can be used to measure absolute poverty (Arimah, 2004; Beck, 2013; Evidence *et al*., 2004; Guillaumont *et al*,2008; and Kpodar and Singh, 2011); iii) the Gini coefficient to measure income inequality (Kappel, 2010; Kpodar and Singh, 2011; Li and Yu, 2014); and iv) average income of the poorest quintile to measure relative poverty (Kappel, 2010; and Kpodar and Singh, 2011).

Many factors could lead to poverty, e.g. ignorance, lack of experience and laziness, but the most important reason is the concentration of capital to a few — a narrow group of people that will lead to (and has begun to show) negative repercussions to human and economic development globally. These negative consequences include deprivation, social

[2] MDGs provided a focal point for governments — a framework around which they could develop policies and overseas aid programmes designed to end poverty and improve the lives of poor people — as well as a rallying point for NGOs to hold them to account, they were too narrow. The sustainable development goals (SDGs) are a new, universal set of goals, targets and indicators that UN member states will be expected to use to frame their agendas and political policies over the next 15 years. The SDGs follow and expand on the millennium development goals (MDGs), which were agreed by governments in 2001 and are due to expire at the end of 2015.

[3] Transitional poverty. It depends on the events or circumstances that have caused poverty for instance medical treatment, affordable housing, and income supports to assist individuals and households. Intergenerational poverty requires a multi-dimensional approach, including a range of early childhood development interventions related to health care, education, nutrition, recreation, parenting, mentoring and others.

[4] http://www.economicshelp.org

unrest, lower investment, and ultimately lower growth, which point to the need for appropriate national and international policies to fight inequality and poverty (Kappel, 2010).

In recent times, the scientific community has renewed interest in exploring the sources and the socio-economic consequences of poverty and inequality. Both academicians and policymakers believe that unequal access to resources is the core contributor towards poverty. One part of literature accordingly stresses that financial market imperfections prevent the poor from investing in productive assets. This market failures may lead to an unequal distribution of credit in favour of the rich people (Jalilian and Kirkpatrick, 2005). As a consequence, inherent disadvantages are transmitted across generations, resulting in persistent inequality and poverty (Kappel, 2010).

In accounting for the changes in the landscape of poverty, its alleviation can be divided into two parts: faster economic growth and improvements in the distribution of income. Besley and Burgess (2003) calculated that: (1) developing countries need a GDP per capita growth rate of 3.8% to cut poverty in half by 2015, which is twice the growth rate of recent decades, and (2) a one standard deviation decline in the Gini coefficient of inequality would cut poverty by about half, in regions with highly skewed income distributions such as Latin America and Africa.

The relationship between financial development and economic growth has been examined extensively in the literature. Theoretical models stress that financial development promotes economic growth via mobilising savings and diversifying risks (King and Levine, 1993). Additionally, Greenwood and Jovanovic (1989) find that the level of economic development induced by financial development could benefit the poor, while Galor and Zeira (1993) argues that financial development would reduce inequality and this claim was supported by Rajan and Zingales (1998), while Levine (1999) explores the relationship between financial development and economic growth where he found a significantly positive relationship.

In order to examine the impact of financial development on poverty and income inequality, some studies have used banking sector development in terms of the contribution of private credit to GDP growth, (Evidence et al., 2004; Kappel, 2010; Kpodar and Singh, 2011) . After controlling for endogeneity, it showed a robust positive relationship between private credit expansion and the growth rate of GDP per capita. Honohan (2003) found that financial development (measured by ratio of private credit to GDP) is negatively connected with headcount poverty, with a coefficient suggesting that a 10 percentage point change in the ratio of private credit to GDP should (even at the same mean income level) reduce poverty ratios by 2.5 to 3 percentage points. Meanwhile, Jalilian and Kirkpatrick (2005), use the ratio of bank assets to GDP to measure financial intermediation in a sample of advanced and developing countries and show a strong positive impact on the income of the poor. Additionally, Guillaumont *et al*, (2008) suggested that the poor benefit primarily from the ability of the banking system to facilitate transactions and provide savings opportunities. They measure using the ratio of M3 to GDP. Indeed, as the financial system becomes healthier and more competitive, it may have more capacity and desire to bear the high costs of small credits (Rajan and Zingales, 2003).

Another aspect of financial development is capital market development relating to stock value traded, and stock market turnover ratio to GDP. Kappel (2010) and Kpodar and

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Singh (2011) find that through a developed stock market, inequality and poverty can be reduced. However, compared to the banking sector, the stock market has a relatively lower, although still significant, effect in reducing poverty.

Moreover, financial development is often considered as the critical elements, as it allows the economic agent to make longer-term consumption and investment decisions and cope with unexpected short-term shocks. Understanding the link between financial development and poverty at the country level will help policymakers design and implement programmes that will broaden access to financial services, leading to a reduction in poverty incidence. In the next section, we look at the thereotical framework and methodology of the analysis.

3. Methodology

This section describes the proposed variables and the methodology to be used for establishing the relationship between financial development and poverty alleviation. This study will focus on the OIC developing countries that consist of 48 countries from 2001 to 2014.

In order to measure the poverty, we used poverty gap (pov) as a proxy for poverty. Financial development will play a role as an independent variable. It will consist of banking sector and as well as stock market. The dimension of banking sector is private credit to GDP (dpc) (Kpodar and Singh, (2011); Kappel, (2010) and Beck *et al*,(2004)). Private credit to GDP might be a good indicator of financial development in less developed countries, where traditional borrowing and lending activities are the key business in financial intermediaton because stock markets are either underdeveloped or non-existent (Seven and Coskun ,2016). Moreover, the other indicators for bank development that extensively used in the literature are private credit by bank (dpcb), banks capital to asset ratio (bcar), bank credit by financial sector (dfc) and bank liquid reserve to bank asset ratio (bliqu)

Recently, stock market development has received much interest in developing countries in the last 20-25 years, given the fact that the financial structure of these countries is mostly bank-based. Therefore, the indicators are stock value traded (stkt), and stock market turnover ratio (stkto), (Kpodar and Singh, 2011 and Kappel, 2010). This study also use three control variables named inflation and trade in order to test for robustness. We also used education factor to control human capital accumulation as many researchers include this factor since this is significant determinant for poverty

We use fixed effect and random effect techniques to address the problems. We run the following equation, which is the basic regression specification from the previous literature.

$$\mathrm{Pov}_{it} = \beta 0 + \beta 1 \ \mathrm{FD} + \Upsilon \mathrm{X}_{it} + \varepsilon$$

Where Pov is poverty, FD is financial development and X will be control variables

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4. Results And Discussion

This study adopts the basic regression specification from the previous literature. We estimate four specifications where's the first two specifications of ordinary least squred and fixed effect without the human capital accumulation factor while the next two specifications we add all the control variables. In all regressions, the left hand side variable is the poverty measures, which are defines as the poverty headcount. Table 1 shows the outcome of the regression of the bank development and capital market as a proxy for financial development towards poverty.

Table 1: Regression of the bank development and capital market as a proxy for financial development towards poverty.

	OLS	FE	OLS	FE
	(1)	(2)	(3)	(4)
stkt	0.124 (0.85)	-0.00885 (-0.23)	0.0221 (0.33)	-0.0159 (-0.59)
stkto	-0.0739 (-1.22)	-0.00192 (-0.07)	-0.00749 (-0.26)	0.0163 (0.88)
bcar	-0.998 (-1.67)	-1.492 (-8.61) ***	-1.293 (-4.32)***	-0.408 (-1.41)
bliqu	-0.195 (-1.24)	0.0629 (0.81)	0.325 (3.06)**	0.0218 (0.40)
dfc	-0.184 (-1.05)	0.00794 (0.15)	-0.124 (-1.56)	-0.0747 (-1.81)*
dpc	0.0992 (0.09)	0.000432 (0.00)	0.553 (1.10)	0.0735 (0.33)
dpcb	-0.117 (-0.10)	-0.162 (-0.05)	-0.436 (-0.81)	0.07533 (0.31)
inf	-0.171 (-0.59)	-0.0587 (-0.65)	0.119 (0.88)	-0.0818 (-1.31)**
trade	-0.00235 (-0.02)	-0.0605 (-1.52)	-0.124 (-241)*	-0.281 (-0.97)
ledu			-6.567 (-7.73)***	-14.12 (-4.23)**
Cons	33.01 (3.67) **	25.57 (7.16)***	122.2 (10.10)***	226.6 (4.77)***
Post Estimation Test				
R2	0.4713	0.8972	0.6712	0.5625

F-test		0.0000		0.000
LM Test		0.0856		0.0769

*Note: The table presents the result for the estimated coefficients and their robust standard errors in parathesis. The dependent variable is the poverty gap at $1.90 a day while the independence variable consist of banking development and capital market as a proxy for financial development. The following are also reported: specification statistics including R-squared, F-test (wald) and as well as LM test for Random Effect to test the difference in coefficients not systematic. *, ** and *** denote statistically significant coefficient at the 10%,5% and 1% respectively.*

From Table 1 it can be said that bank development fails to benefit in OIC developing countries. We find that only bank capital to asset ratio shows the negative significant result. However, when we focus on capital market, it shows both variables were not sigficant in reducing poverty. That is, the direct effect of bank development is still insignificant for OIC developing countries eventhough we had control for inflation and trade openness. Inflation shows the correct coefficient sign; however, it has no significance relationship with poverty. Economic literature has debated about the impact of inflation and income inequality where they stated that higher inflation tends to redistribute wealth between creditor and debtor, with the latter repudiating debt when unexpected inflation is high. Our estimations favour the former explanation where higher inflation leads to lower poverty in Muslim developing countries. Fixed effect (FE) explore the relationship between predictor and outcome variables within an entity. Each entity has its own individual characteristics that may or may not influence the predictor variables, the f- test for fixed effect shows the significant result where it telling us that fixed effect is a better analysis in this study compared to OLS. On the other hand, the LM test for random effect shows insignificant result, therefore OLS should be chosen rather than RE

Across the specification, when we add education as our control variable, it seems that the financial development plays a very well function in alleviating poverty especially from the banking development sectors same as Seven and Coskun (2016) and Honohan (2003). Bank capital to asset ratio and bank liquid reserve to bank asset ratio shows the significant results in alleviating poverty.The sign and significance level of the estimated coefficients did not change dramatically. However, the stock market development still shows the insignificant result for poverty alleviation same as previous result. Yet, still the negative relationship shows that stock market is an important factor to reduce poverty. The interesting points come when we add education variable. From the analysis, the education variable shows significant and negatively relationship with poverty alleviation.The finding was supported by Seven and Coskun (2016). The negative sign indicate that higher education can help to reduce poverty in Muslim developing countries because with education can enables individuals to acquire and use knowledge and skills to get a healthier life. Thus it can tell us that the human capital accumulation also can helps in alleviating poverty besides financial development.

5. Conclusion

Recently, the question of whether financial development can reduce poverty has been remaining examined over the last two decades. Even though, a large body of literature has been discussed that financial sectors are correlated with economic growth, theory encounter the predictions about the impact of financial development on poverty reduction. This study tests the hypothesis wheter financial development that consists of banking development and stock market would reduce poverty, in the context of Muslim developing countries. We use data from 48 Muslim developing countries for the period 2001 to 2014.

There are several points emerge in this study. First, with regard to the regression between bank development and poverty, we find that bank development measured by bank to capital asset ratio has a negative and significantly effect to poverty reduction. Next, the results of stock market development show the insignificant result with poverty, where it can be said constant with the fact that in Muslim developing countries the financial structure is most in banking sectors compared to stock market development. Third, it advocate the simultenaous effects of banking and stock market factors may not fully capture the effect of financial development and poverty where it shows the relationship between financial development and poverty apply negative but statistically insignificant effect.Thus, suggesting the investigation the separate effects of banking and stock market developments.Lastly, the results suggest the countries with high inflation are facing difficulties to alleviate the poverty, recommending the muslim developing countries need the steady macroeconomic factors. The regression results also suggest that the human factor accumulation representing by education have a negative significant impacts on poverty.

The negative and weak impact of financial developments and poverty alleviation indicate that financial development failed to fulfill the wants of poorest people of society in Muslim developing countries. Aforementioned, financial developmet is all about policies and programmes that carefully managed but extremely naïve and actually failed the poor. In order to ensure equal access, it is necessary to strengthen human capabilities and prepare them for productive employment.

This analysis has focused on the factors of financial development that consists of banking and stock market sectors due the availability of the data across countries and time, hence we do believe that the accessibility and the penetration of the financial services will be more relevant to alleviate poverty.It same goes to the factors of microfinance. Therefore, we leave to future researcher to explore the other factors of financial development on poverty reduction.

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