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Financial Inclusion: Why it's a Hot Topic & What it Means

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FINANCIAL DEEPENING AND ECONOMIC GROWTH

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Outline

- Finance – growth nexus
  - Why do we care?
  - What do theoretical and empirical economics offer?
- Functions of financial systems and financial development
- Finance, income distribution and poverty
  - Financial inclusion
- Measuring access to financial services
  - *Financial Access* by CGAP/WBG

Finance – Growth Nexus

Finance – Growth Nexus

- Finance is not that important for growth!
  - Meier & Seers (1984). *Pioneers of Development Economics*. Oxford U Press: NY.
    - No mention of finance!
  - Lucas (1988). "On the Mechanics of Economic Development," J of Monetary Economics 22: 3-42, on p. 6 dismisses finance as:
    - An "over-stressed" determinant of economic growth
  - Robinson (1952). *The Rate of Interest and Other Essays*. MacMillan: London, p. 86:
    - "where enterprise leads finance follows."
- Ignoring the finance – growth nexus significantly limits our understanding of economic growth.
  - Miller (1998). "Financial markets and economic growth," *J of Applied Corporate Finance* 11:8-14, p.14:
    - "[the idea] that financial markets contribute to economic growth is a proposition too obvious for serious discussion."
  - Bagehot (1873), Schumpeter (1912), Gurley and Shaw (1955), Goldsmith (1969), McKinnon (1973)

Why do we care?

- Identifying the finance –growth nexus will
  - Have implications for policy
  - Point out directions for future policy-oriented research
- If it turns out that finance causes growth, then:
  - Financial sector policies will get the priority on policy makers agenda.
  - Research on political, legal, regulatory and policy determinants of financial development will get priority on researchers agenda.
- If it turns out that growth causes finance, then:
  - Research on the determinants and the evolution of financial systems will get priority on researchers agenda.

Evidence from Economic Theory

- Market frictions
  - Financial arrangements change incentives and constraints facing economic agents.
  - Financial instruments, markets, and institutions may arise to mitigate the effects of information asymmetries and transaction costs.
- Overall, financial systems may
  - Influence savings rates, investment decisions, technological innovation
  - … and long-run growth rates.
- Financial sector provides "real" services by reducing information asymmetries and transaction costs.

Evidence from Empirical Economics

- A variety of models and techniques
  - Each with serious shortcomings
- Major findings:
  - Countries with better functioning banks and markets grow faster.
  - Issue of causality and related problems in empirical analysis do not drive the results.
  - Better functioning financial systems => fewer external financing constraints for firms & industries as a whole.
    - One mechanism through which financial development matters for growth
- Question: How do you measure financial development?

Functions of financial systems & financial development

To ease information, enforcement and transaction costs, financial systems:

- Produce information ex ante about possible investments and allocate capital
- Monitor investments and exert corporate governance after providing finance
- Facilitate the trading, diversification and management of risks.
- Mobilize and pool savings.
- Ease the exchange of goods and services.

There are differences across countries in terms of how well financial systems perform these functions.

These functions influence savings and investment decisions

  - … and hence, resource allocation and welfare.

Financial development

- … occurs when financial markets, instruments, and institutions reduce and perhaps eliminate information asymmetries and transaction costs, and ease enforcement
  - By doing a better job at providing the five functions
- Policies to improve any one dimension will have implications on resource allocation and welfare depending on the state of the rest of the economy.
- Note: Financial development => change in resource allocation to increase productivity growth (not increase savings only) => economic growth

Finance, income distribution and poverty

- Financial inclusion

Poorly functioning financial systems

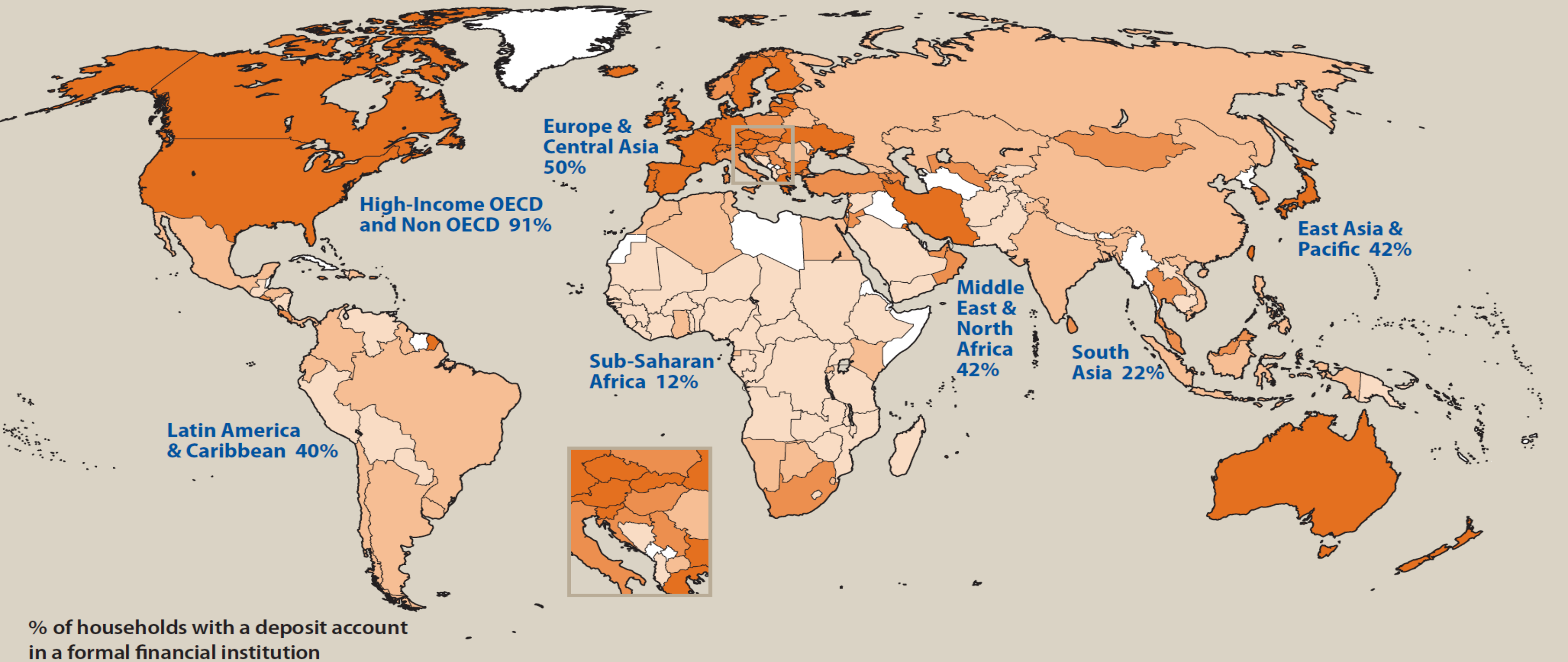
- Information asymmetries => credit constraints
  - Worse for the poor to access formal credit due to
    - Lack of own resources for funding or collateral or political/social connections
- A poorly functioning financial system will
  - Slow down aggregate growth due to inability in facilitating efficient resource allocation
  - Increase income inequality due to inability in providing equal opportunities/access for everyone
    - But what if it is particularly the rich and well-connected who benefit from the initial phases of broad financial development?
      - Need to target the poor specifically?

Financial Inclusion

Half the world has no access to formal financial services (Financial Access 2010)

MAP 1.1

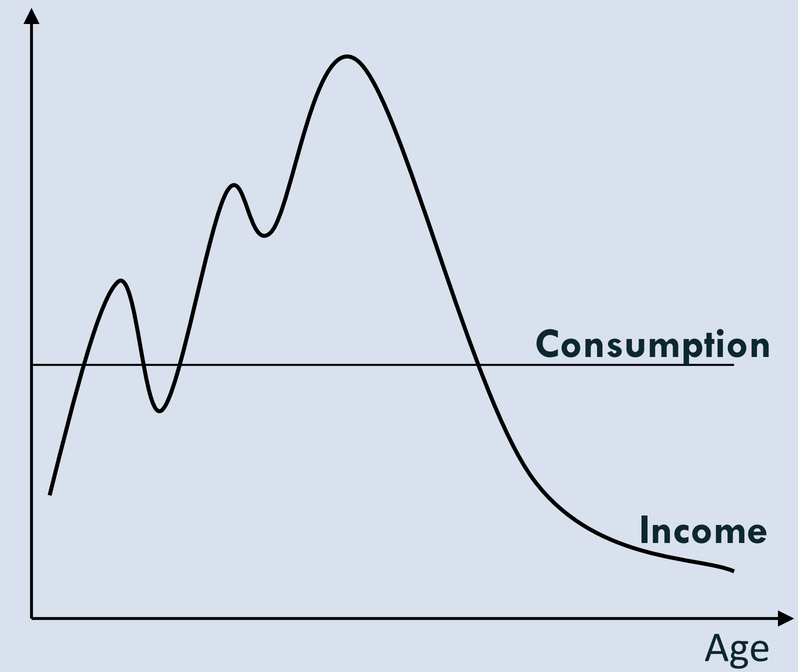
Percentage of banked households, 2009



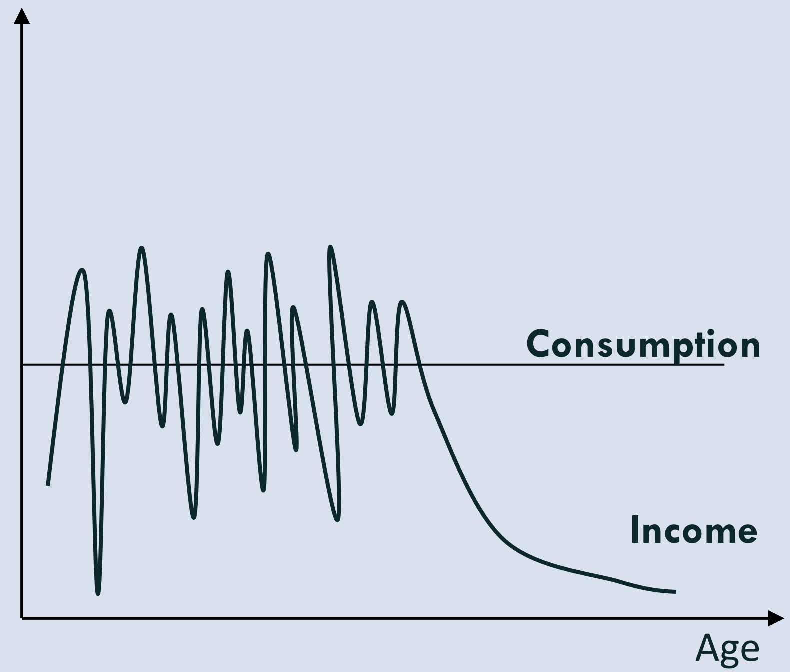
Note: OECD = Organisation for Economic Co-operation and Development

The map uses data from household surveys including Living Standard Measurement Surveys where available, as well as regional sources: for the EU, the European Commission's Eurobarometer, Special Barometer 260 (2007); for Africa, FinMark Trust's FinScope; for Latin America, Tejerina and Westley (2007) and the MECOVI database and Barr et al. (2007); and Nenova et al. (2009). For countries for which these data are unavailable, predictions based on an econometric model with number of deposit accounts per 1,000 adults and number of branches per km^2 from the *Financial Access* database are used. See the section on Methodology for more details. Data for Taiwan (China), Hong Kong SAR (China), and Puerto Rico (US) have been broken out from the national dataset.

Life-cycle consumption



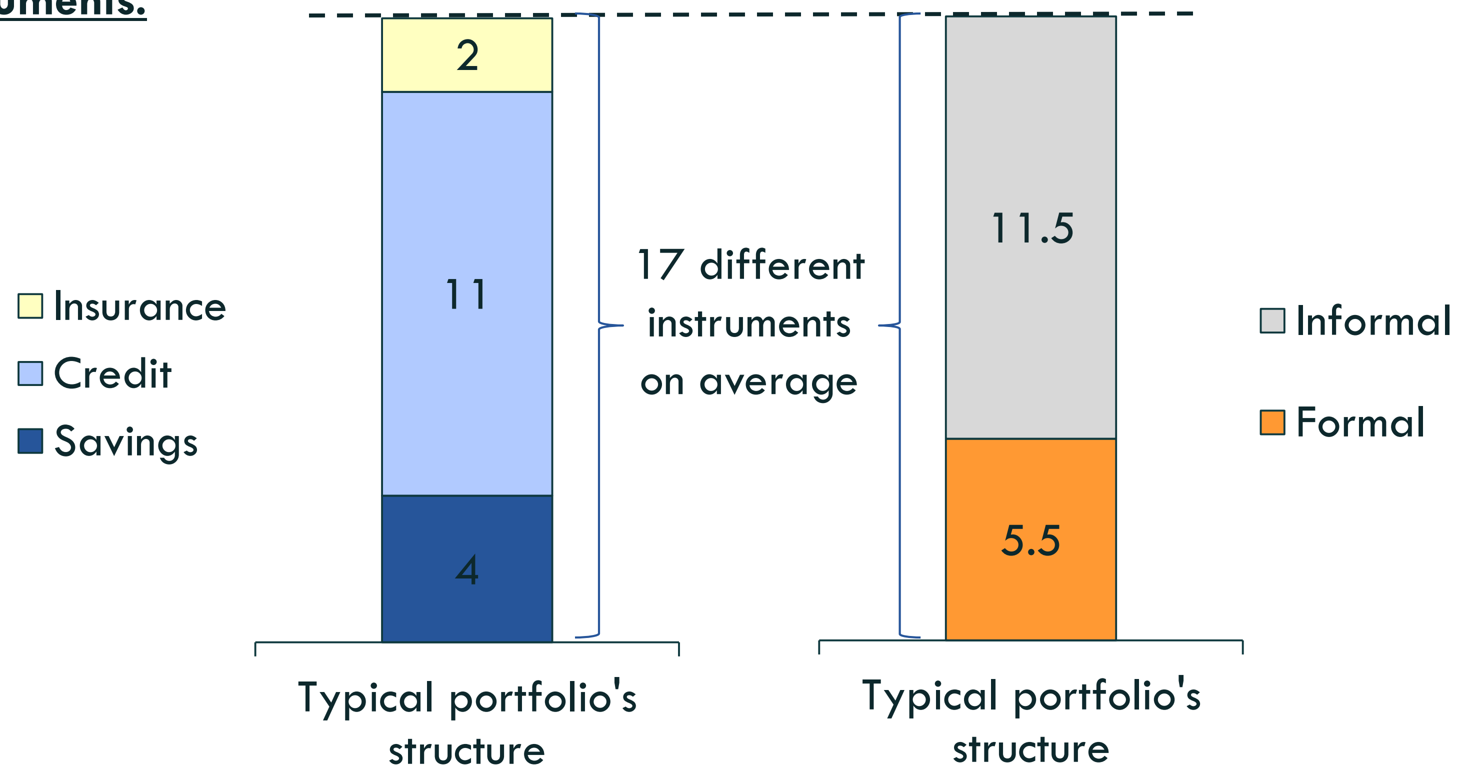
Rich household consumption pattern



Poor household consumption pattern

Poor people use finance actively

Over the course of one year poor people use on average 17 different financial instruments.



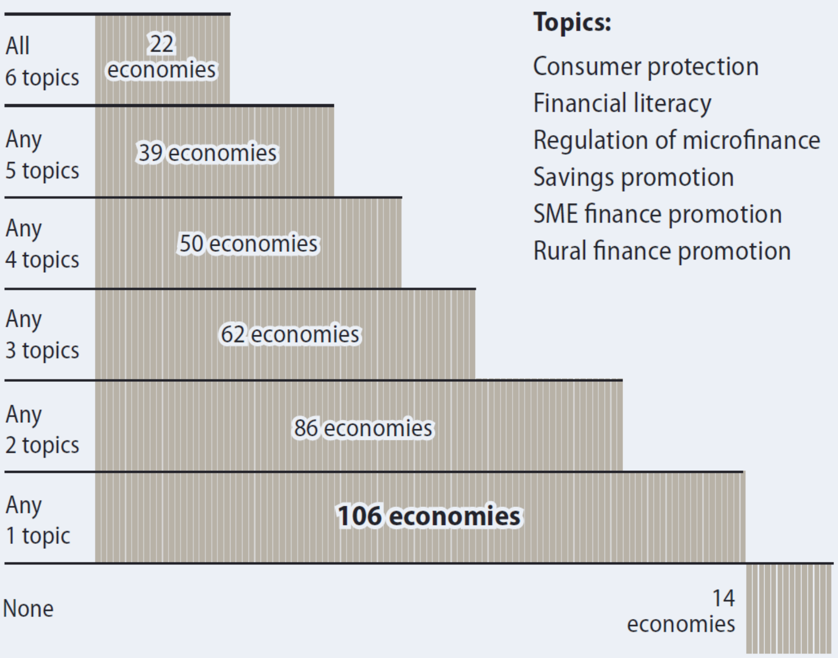
Source: *Financial Diaries*

Financial inclusion – importance

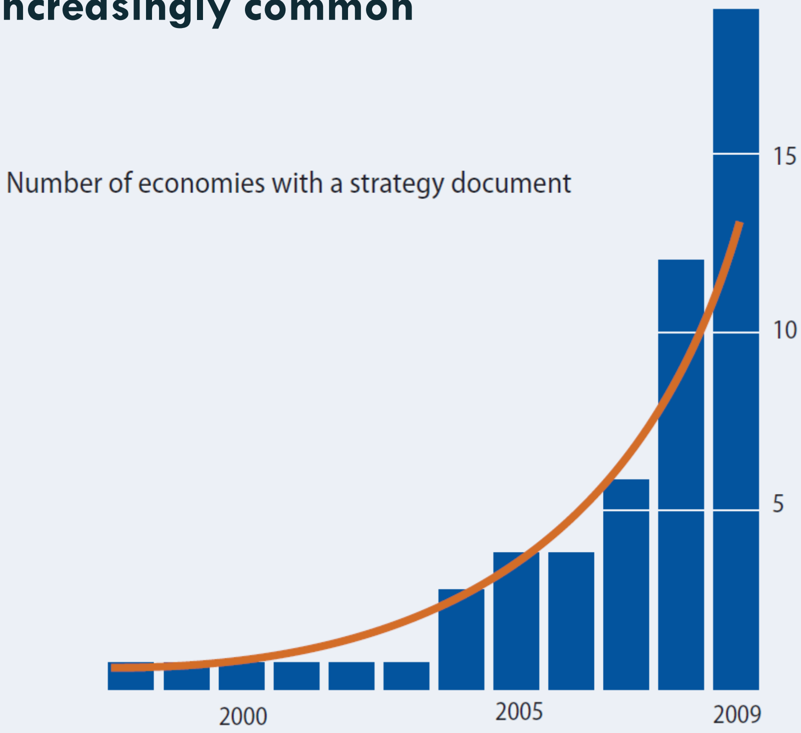
- Finance exerts a disproportionately large, positive impact on the poor and hence reduces income inequality (Beck, Demirguc-Kunt & Levine, 2004)
- Financial instruments are critical to:
  - Smooth consumption
  - Manage cash flows
  - Cope with shocks and emergencies
  - Have accumulated resources for important events
- Informal financial services are, in general, more costly and less reliable.

At least one aspect of financial inclusion is under purview of the financial regulators in 90 percent of economies.

Most regulators are responsible for at least one topic of financial inclusion

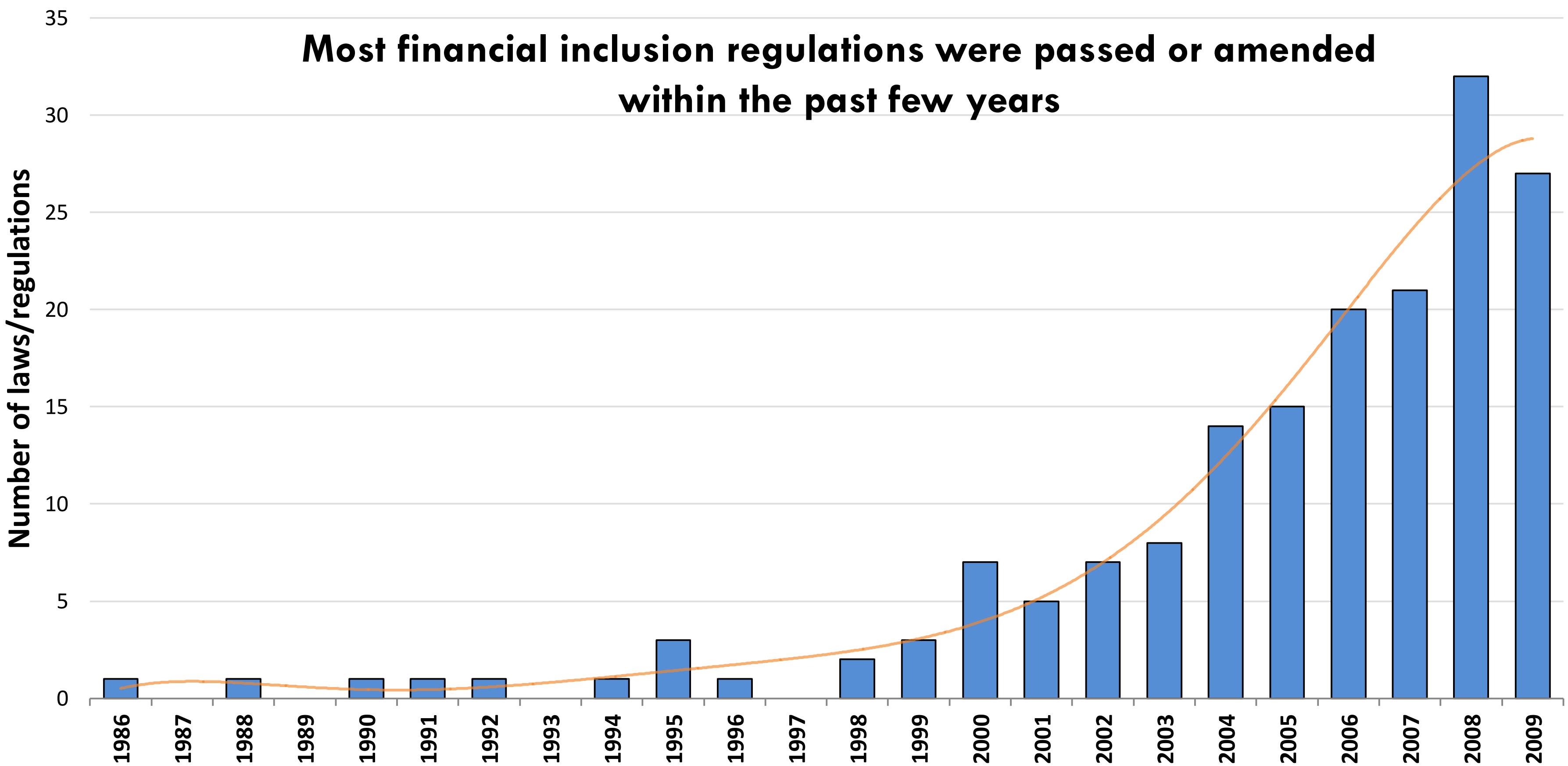


Financial inclusion strategies are increasingly common



Source: CGAP/WBG *Financial Access*

More financial inclusion related regulation is passed every year

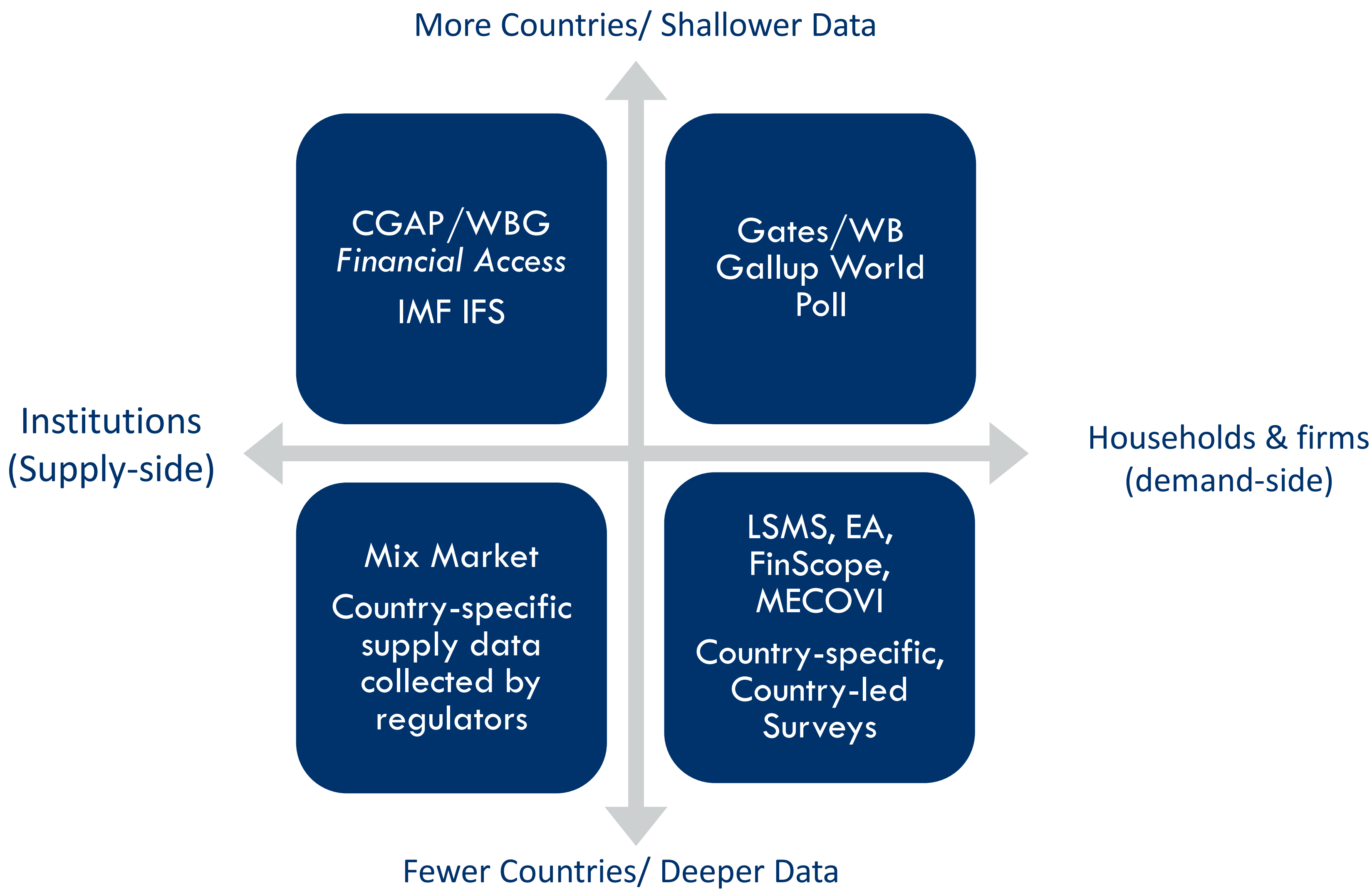


Note: The graph is based on a sample of 35 developing countries worldwide. Dates are based on the latest amendment of the law. The laws taken into account here are mainly focused on microfinance institutions, financial consumer protection, and branchless banking. They are not a comprehensive list of laws addressing financial inclusion .Thus, the graph might be understating the number of financial inclusion laws in this sample.

Source: CGAP Financial Inclusion regulation center

Measuring access to financial services

Current data landscape



CGAP/WBG *Financial Access* includes data on:

- Indicators of financial access for regulated financial institutions, including non-banks

Repeated annually

- Policies and regulations
  - Financial Access 2009
    - Financial services through postal networks
    - The use of bank agents
    - Regulations related to opening accounts
    - Branch regulations
    - Credit regulations
    - Transparency and consumer protection
  - Financial Access 2010
    - Financial inclusion mandates
    - Consumer protection legislation
    - SME access to finance

Changes every year

More flexible

CGAP/WBG *Financial Access* uses institutional approach

- Access to or use of the financial services of a particular type of institution (regulated institutions only)
  - Commercial banks – banks with a full banking license
  - Cooperatives, credit unions & mutuals – owned and controlled by members (customers)
  - Government savings or development banks – specialized state-owned financial institutions
  - Microfinance institutions – lend and possibly take deposits from the poor, often using specialized methodologies such as group lending
  - Other institutions providing deposit and/or credit services

Data on financial inclusion – by type of institution

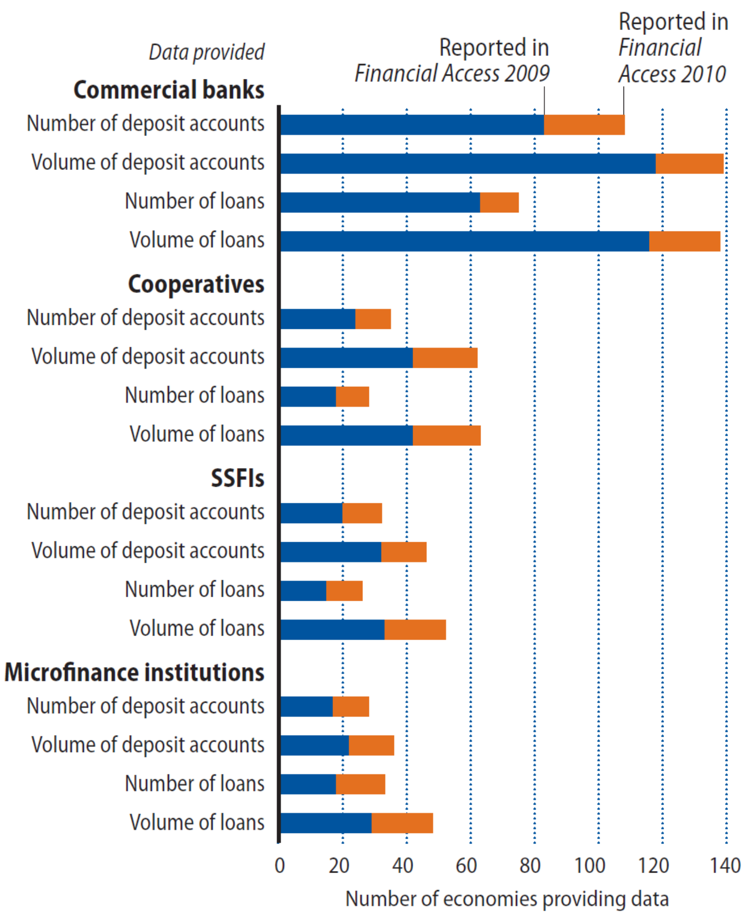
- Number of institutions
- Number of deposit accounts
  - Held by individuals and non-financial businesses
  - Number of individuals and non-financial businesses with a deposit account
- Value of deposits
  - Held by individuals and non-financial businesses
- Number of outstanding loans
  - Held by individuals and non-financial businesses
  - Number of individuals and non-financial businesses with an outstanding loan
- Value of loans
  - Held by individuals and non-financial businesses
- Number of branches
  - In urban and rural areas
- Number of agents (non-branch retail locations)
- Payments data on ATMs and POS terminals

Snapshot on data availability

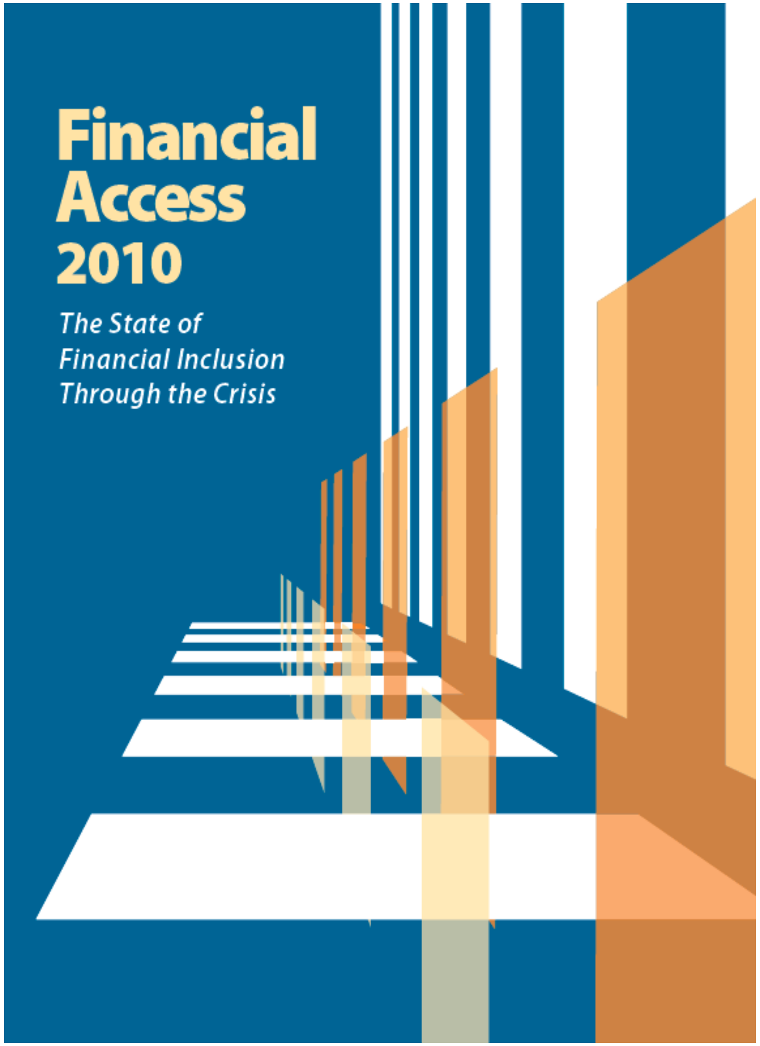
- Data availability – improving over time, especially for the major financial inclusion indicators
- Problems with breakdown by types
- SME data availability
  - SME lending volume: 50 countries
  - Number of loans to SMEs: 26 countries
  - Number of SMEs with loans: 16 countries

FIGURE 5.1

More economies provided data in 2010



Source: Financial Access database.
Note: SSFI = specialized state financial institution.



http://www.cgap.org/financialindicators

Caroline Mauldin

- **Caroline Mauldin, Office of Under Secretary for Democracy and Global Affairs at U.S Department of State**. Caroline Mauldin joined the Obama Administration in September 2009. She supports the work of the Under Secretary of State for Democracy and Global Affairs, Maria Otero, on a range of issues including financial inclusion, innovation, technology policy and global partnerships. In this capacity, Caroline works closely with US embassies, USAID, the Treasury Department, and other U.S. government agencies to coordinate and elevate financial inclusion in U.S. foreign policy. Prior to joining the State Department, Caroline worked for global microfinance leader ACCION International and was on the founding team of the Center for Financial Inclusion. Caroline has also worked for Oxfam America and The Carter Center and holds a degree with honors in International Relations and Latin American Studies from Tufts University.

Government Role in Financial Inclusion

1. Regulation
2. Policy
3. Government as a Catalyst
4. Government as a Player

#1 Regulation

- G-20 development of financial inclusion experts group
- Alliance for financial inclusion
- 90-percent is the percentage of governments who are working in some regard with financial inclusion

#2 Policy

- National ID systems
- Establishment of Credit Bureaus

#3 Government as a Catalyst

- Colombia, which has developed Banca de las Oportunidades, which is not in fact a bank, but it’s a national financial inclusion strategy that has political buy-in at the highest levels
- Government can also be a catalyst in terms of investment

#4 Government as a Player

- We increase accountability, transparency, and that also security is increased, both by people not having to carry cash around and also people getting paid on time
- Government as a player is great for the financial inclusion sort of industry as a whole, but it also is good for the government itself

What the State Department is Doing

- Education
- Coordination
- Elevation

Lauren Hendricks

- **<u>Lauren Hendricks, Executive Director of the CARE Access Africa initiative</u> -** Access Africa aims to reach 30 million people in sub-Saharan Africa with access to a basic suite of financial services within the next decade. Prior to the Access Africa initiative Ms. Hendricks was the Director of the Economic Development Unit for CARE USA, responsible for strategic direction and technical leadership for over 100 active microfinance and enterprise development programs in 54 countries. Ms. Hendricks currently serves on the Board of Directors and on the Investment Committee for MicroVest, a capital management firm investing in microfinance institutions. Ms. Hendricks also serves as the Chair of the Board for the SEEP Network. Prior to joining CARE Ms. Hendricks was a program specialist at the Center for Institutional Reform and the Informal Sector (IRIS) at the University of Maryland. She has over 15 years of experience evaluating, designing and promoting the development of microfinance programs worldwide. She spent three years in the Republic of Georgia with the International Rescue Committee managing a microfinance program and overseeing it's transformation into a locally registered and managed institution.

Regulatory and Policy Issues

- Instituting risk space
- CARE is looking to reach 30 million people
- CARE’s strategy for financial inclusion is based on starting from these savings groups and using these savings groups as a foundation, and what we feel is often a basic and necessary first step for the very poorest households to be included into the formal financial sector
- One of the key things about the savings groups is that they start at a point of savings rather than of borrowing, and research has shown that particularly for the very poorest households, they would prefer to save than to borrow

Regulatory and Policy Issues

- One of the features for extremely poor households is that even when they save informal institutions, they save for very short periods of time
- Financial institutions need to treat village savings and loan groups as clients and as a market
- Working with Barclay's in Uganda, Kenya, Ghana, Egypt, and Mozambique to develop what the Brits call "bespoke products"
- Mobile payments platforms, like M-Pesa or ZAP, which is the Zain system; or Mobile Money, which is the MTN system, are able to be used to link into a formal financial institution account

Regulatory and Policy Issues

- There are countries, Rwanda for example, which has recognized the SLAs in the financial legislation and allows VSLAs to operate as informal groups, but has outlawed the linkage between VSLAs and formal financial institutions
- Work with governments to ensure that policies that are enacted, particularly around women's financial inclusion, go from a policy to an implementation phase

QUESTION & ANSWER

Question #1

I would love to get all of your opinions about the Gates' commitment of $500 million for savings over five years. What do you think that means for the field, both positive and negative? And how would you like to see that commitment move forward?

Question #2

So I’m wondering will there be a concerted effort on the part of, you know, the folks on the panel, the organizations, or anyone else in the field, will there be a concerted effort to put those informal groups at the front of this movement? Because they were absent from Mrs. Gates’ remarks in Seattle.

Question #3

All of the research around poor peoples' income, showing that it's small, it's just not being leveraged in the right way. I'm wondering, Lauren, in your experience working with financial institutions, how widely accepted is that tendency that the research is showing that, people really do have money, it's just not leveraged in the right way, and people already are using informal services, so they really are sort of financially literate.

So when you work with a financial institution like Barclays or the handful of other MFIs or otherwise, what do bank managers say about that?

Question #4

Is it just because we don’t really know, or is that something that is just the situation, the structural situation of the microlending movement right now?

And then second of all, in terms of the financial cooperatives, we’ve noticed that that does exist in rural areas and it does exist to a scale that could be used towards funding lower-middle income SMEs. And so do you see this kind of system being able to support small businesses of producer organizations in rural areas as well?

Question #5

Mobile technology offers opportunity for leapfrogging financial inclusion. The challenge is how lethargic bureaucrats are persuaded to support creating the right linkages. Was any discussion in Seattle to address this challenge in how Gates Foundation can help in leveraging mobile technology to increase savings and promote financial inclusion and how the United States government can help create nexus among the various players?

Question #6

The story you told about the police officer getting a small percentage of his check as everyone takes their piece. And in my experience the systems there that can seem haphazard and inefficient are actually quite intentional and deliberate in the way they're set up, because everyone is benefiting and getting their piece. I'm just curious how you guys plan to get buy-in from the Congolese government, for example, to change a system from which many are obviously benefiting?

Question #7

I'd like to hear your opinion on how these new systems, these new channels can be in some way sold. How can the business case be made to those private sector actors, whether they're telcos, banks, insurance companies?

And will we be able to get them involved in that system without having to fund them to do this?

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Jennifer Maurer, RESULTS

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