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Facing up to the political realities of financial inclusion

Time for donors to re-think their approach?

Financial inclusion is rising rapidly up the policy agenda but there is a tension between donors' pursuit of 'best practice' institutional and policy reforms that are intended to develop market-based financial systems, and governments' more direct 'activist' interventions, such as offering loans to the poor with preferential interest rates. This *Briefing Note* argues that donors need to adopt a more pragmatic approach, rooted in the political economy of individual countries. Without this their efforts are likely to be doomed from the start, with their proposed inclusion policies left on a shelf, or regulation distorted or circumvented.

Background

Financial inclusion is increasingly being viewed as a foundation stone for economic growth, job creation and even financial stability. Technological innovations, such as the impressive rise of mobile money in countries such as Kenya, have further strengthened interest in this issue. Recently, the developing and emerging-market countries that are home to more than 90% of the world's estimated 2.5 billion unbanked have, under the 2011 Maya Declaration, set out measurable sets of commitment to increase financial inclusion.

However, government financial inclusion policies often deviate from the market development approaches that donors are increasingly adopting. These diverging scripts leave donors with difficult choices about how to engage. Should they pursue actions they consider as 'best practice' in market development but which are unlikely to gain much traction? Or should they work around government, but by doing so, move away from the goal of systemic change that a market development approach promotes?

Key points

- Donors need to incorporate a political economy understanding of the dynamics of financial inclusion, to bridge the tension between activist and market development approaches to financial inclusion.
- By 'working with the grain' of these political economy dynamics, donors can expand the space for reform.
- There are a number of examples of donors attempting to work with the prevailing political economy, from assisting particular forms of regulation, to working to improve the functioning of state-run finance initiatives. The Financial Sector Deepening Trusts, established in some African countries, in particular have the potential to develop long term relationships with Governments that can, over time, expand the space for reform.

Briefing Note

The evolution of approaches to financial inclusion

Forty years ago, developing country governments sought financial inclusion goals primarily through the establishment of state-owned financial institutions such as development banks and direct-lending schemes, sometimes called an '**activist**' or '**interventionist**' approach to financial inclusion.

The shift to neo-liberal economic reform policies in the 1980s was borne of both the failure of many state-owned banks and development financial institutions to be sustainable, and the poor outreach and impact of directed and subsidised credit schemes. While financial market liberalisation drove reform in these sectors – known as a '**modernist**' approach – donors also sought to build alternative institutions in the market, for example by engaging with NGOs delivering credit and gradually developing microfinance as a financially sustainable sector. Alongside this, the increased recognition that governments can play an important role in setting the enabling environment for the market has become known as a '**market development**' approach to financial inclusion.

Tensions between government and donor approaches

As governments have become increasingly interested in financial inclusion goals, tensions between the approaches of donors and governments have emerged. For governments, financial inclusion strategies are an integral part of wider goals, which may include job creation, the uptake of specific services or the promotion of particular sectors or regions. Examples of initiatives in East Africa include governments, such as in Rwanda, Ethiopia and Uganda, setting up schemes that offer preferential loan interest rates through rural co-operatives. Zambia too has recently introduced interest rate caps to the microfinance sector. These initiatives, whilst leading to much concern among the development community regarding sustainability, often help to legitimise governments in the eyes of the population.

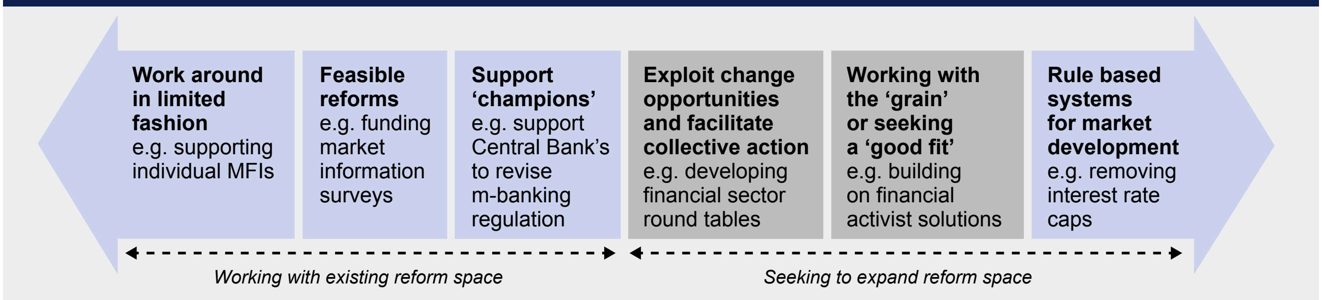
Donors however are increasingly adopting approaches to financial inclusion based on developing the broad financial system, where governments are expected to pro-actively set rules and parameters to enable the private sector to deliver financial services through market competition and innovation. Examples include developing mobile-banking regulations that assist new market actors or establishing credit bureaux and collateral registries or offering 'smart or market promoting' subsidies to incentivise innovation and market entry. This new appreciation of the enabling role of governments has led to a need for donors to engage more deeply with them.

The need for a political economy perspective

Engaging more deeply with recipient governments for financial inclusion means looking beyond this dichotomy of modernist and activist approaches towards a third approach that recognises that financial inclusion policies are essentially local and must be tailored to political and institutional environments.[1]

Figure 1 presents a stylised spectrum of options for donors. The left-hand end of the spectrum represents minimal engagement in which donors work around the government by working only with the private sector, for example with microfinance institutions. The right-hand end of the spectrum represents the relatively rare case where it is possible to engage fully with government using a market development approach. The space in between offers a number of more fine-grained options for policy engagement and market development. These approaches are already being employed by some donors who are making politically informed decisions about where and how to engage. This ranges from providing financial market information (e.g. FinScope surveys) to new funding options, such as challenge funds and credit guarantee schemes.

Figure 1: A spectrum of engagement[2]



1 World Bank, (2011) *Financing Africa: Through the Crisis and Beyond*. World Bank, Washington.
2 Adapted from, Booth, D. (2011) *More realistic approaches to governance: Expanding the spectrum of reform*, March 15 2011, Governance for Development Blog.

Through a more in-depth and explicit understanding of the politics of the financial sector it may be possible to expand the reform space at the right-hand end of the spectrum by exploiting change opportunities and working with the grain. This approach seeks to work with and build on the dynamics of activist solutions. This is the most challenging approach for donors – especially when they regard country governance to be weak and hence policy to be vulnerable to significant rent-seeking.

Expanding the reform space by "working with the grain"

So what might expanding the reform space entail? It could involve working through government microcredit schemes to achieve incremental reform, for example by enhancing credit methodologies or introducing new monitoring systems that help governments understand if they are meeting financial and/or socio-political objectives. More ambitiously, donors may work directly with governments, bearing in mind that what constitutes success might go beyond crowding-in private actors and may include targeting specific groups as part of the government's wider development strategy. For example, in Tanzania and Mongolia, external management contractors were employed in the early 2000s to work with state-owned banks to improve their performance and leverage their networks as an explicit strategy to work with, rather than around, the state.[3]

Once this mindset is in place, the scope for innovation grows. Input subsidy schemes, such as Zambia's, are routinely criticised by donors for their cost and inefficiency. However, given that the system has established links between the Ministry of Agriculture and vast numbers of farmers, across all divides, thought could be given as to how to leverage it to drive rural financial inclusion. This is already underway to some extent with a shift in the distribution of subsidies from cash to e-vouchers via mobile phones.

One donor modality with significant potential to work with the prevailing political economy is the Financial Sector Deepening Trusts (initiated by the UK's DFID and supported by other donors) that have been set up across a number of African countries. These multi-donor bodies not only bring external funding sources into a degree of alignment, but have the space to work on different parts of the spectrum at the same time. For example, they can work with the private sector to help build retail capacity at the micro level while addressing the institutional and supervisory environment at the macro level. Moreover, by building a presence as a supportive and engaged player in the sector over the longer term, Trusts can input into critical decision-making at strategic moments. For example, FSD Kenya encouraged the Central Bank to adopt a light regulatory touch to the development of mobile money, which has helped produce impressive m-banking results. Hence working with the grain is not mere blue-sky thinking.

Bringing political economy analysis to life

A crucial element of knowing how to pick these opportunities and when, is the ability to gain a deep-seated understanding of the underlying incentives and dynamics, and to develop credible relationships with financial sector players. Table 1 outlines some indicative questions for political economy analysis of financial sectors in developing countries.

Table 1: Political economy analysis and financial inclusion

Area of Analysis	Indicative questions
Contextual analysis	What are the salient features of the political history and socio-economic status of the state? How do elites use rent allocations to maintain power? How are these channelled through the financial sector? How important is the financial sector in terms of tax revenue, party financing and other roles? What is the history of state involvement in the economy and what are the dominant models and ideologies, for example the role of the market versus the state?
Sector Policy Process	What is the relationship between the Ministry of Finance, Central Bank and others interested in financial inclusion? Are financial sector policymakers and regulators insulated from elite interest? For example, how independent are regulators? Who are the winners and losers from market development reforms? To what extent do non-government actors, such as CSOs and the electorate, exert influence on financial inclusion? How do previous reform initiatives influence current perceptions? How credible are the actions of key actors such as regulators? Where are the main ideas in the sector coming from, for example from minstries, donors or advisers?
Reflexive analysis	Do you understand 'enough' of the political economy of the main players, including the rules of the game, to work directly with the government? Do you see the problem in the same way as the government? How credible would it be to push for market development reforms? Are you connected to the appropriate networks/champions? If not, can you be? Do you have the instruments and flexibility to take less risk-averse options?

3 Both banks were later sold to overseas investors.

Conclusion

This Briefing Note has identified an increasingly present tension between governments and international donors in the promotion of policies for financial inclusion: donor approaches that are market-oriented frequently come into conflict with the more activist policies of developing country governments. This has led to a spectrum of donor engagement strategies in the financial sector determined by implicit assessments of local realities and concerns about weak governance.

This Briefing Note argues that by undertaking more explicit, systematic political economy analysis, donors can better understand the dynamics behind activist policies. This enables them, first, to better understand and be more reflexive about the scope for pro-active engagement towards financial inclusion and, second, to potentially expand the space for reform by working with the grain of these political economy dynamics. This enables more ambitious policies that are better informed of the risks involved.

Bringing the centrality of this political process into analysis of market development, provides scope to find new ways to engage, which are both innovative and sustainable.

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Further reading

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