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The political economy of financial inclusion: Working with governments on market development

Susan Johnson and Richard Williams

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THE POLITICAL ECONOMY OF FINANCIAL INCLUSION: WORKING WITH GOVERNMENTS ON MARKET DEVELOPMENT

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The political economy of financial inclusion: Working with governments on market development

Susan Johnson and Richard Williams

Abstract

This paper examines the tensions that exist in financial inclusion policy between donor approaches founded on market modernism and governments with more activist leanings. It draws on political economy analysis – now frequently used by donors themselves – to demonstrate the underlying dynamics at play. It discusses how donor policy for microfinance has moved from disengagement to increasing engagement, as visions for financial inclusion require government involvement in building markets. We argue that there are opportunities for finer-grained understanding of the space for engagement and that, as a result, there are approaches to donor engagement, which may push the envelope of feasible strategies. In particular, the policy goal of inclusion may be achieved by a variety of means that go beyond the current orthodoxy. Finding policy that fits involves understanding the conditions under which activist governments are more likely to achieve developmental outcomes rather than to assume they cannot.

Key words: Political Economy Analysis; Financial Inclusion; Donor Engagement; Market Development; Pro-market Activism; Africa

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1 Introduction

Financial inclusion (FI) seeks financial sector development, which provides poor people with 'effective' access[1] to financial services, through formal institutions, and was adopted by the G20 as a policy goal in 2010.[2] This goal increasingly involves donors working with 'governments' who have a critical role in setting the conditions in which these formal institutions operate. But frequently there are quite different ideas about what this role should be. Indeed, despite three decades of donor led pro-market reforms, 'activist' policies are resurgent in some contexts. Donor engagement with governments to develop the financial sector is often therefore a difficult process in which motivations and interests are in tension.

A political economy approach is used in this paper to explore this tension. Donors, have increasingly used such approaches – under the umbrella of political economy analysis (PEA) – to better understand the country contexts in which they are engaging and to make strategic decisions about their interventions by analysing the interests and incentives that constrain change (DFID 2004; 2009, World Bank 2008; 2009). A more general approach of donors, in which PEA contributes, has been to identify the scope for intervention towards good governance objectives. More recently, however, the dominant good governance agenda that has underpinned donor intervention has been identified as failing – especially in Africa. It is argued that it is necessary to understand the political economy of this failure and challenge donor thinking about the scope for working with context specific approaches by recognising that there may be scope for engagement that 'works with the grain' by taking politics and institutions into account (Booth 2011). This may, in turn, require building on rather than avoiding existing activist approaches.

This paper brings this challenge to bear on the specific arena of FI policy to examine the scope for engaging with governments in the pursuit of FI. Its purpose is to both understand the political economy constraints to reform in the financial sector and to go beyond this in considering the potential for a re-visioning of FI policies and alternative approaches to engagement with governments.

First, we outline the origins of current FI policy. Second, we introduce a political economy perspective and its recent challenge to development policy. Third, we use this political economy approach to identify the constraints to FI for the insights it offers: (i) into the role of the financial sector in the economy as a whole; and (ii) at the level of the institutions of the financial sector itself. Fourth, having undertaken this review we then consider the spectrum of options for engagement that donors are faced with and discuss how these strategies have been

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1 "'Financial inclusion'… refers to a state in which all working age adults have effective access to credit, savings, payments, and insurance from formal service providers. 'Effective access' involves convenient and responsible service delivery, at a cost affordable to the customer and sustainable for the provider, with the result that financially excluded customers use formal financial services rather than existing informal options." (GPFI and CGAP n.d.:1).

2 See http://www.gpfi.org/our-work/work-plans/g20-financial-inclusion-action-plan, last accessed: 30 May, 2013

operationalised in the financial sector. We then raise the challenge for donor engagement that an alternative 'working with the grain' policy strategy would mean in this sector.

2 Financial inclusion policy and the middle way of 'pro-market activism'

In the last decade, there has been a move away from targeting poor people through specialist microfinance organisations to building the overall financial market and seeking their inclusion in it (World Bank 2008). This is based on the view that competitive markets are the key means through which innovation and competition will result in falling transactions costs and the scale and sustainability required to overcome the significant levels of exclusion that remain (Porteous 2004; Honohan and Beck 2007). It has arisen out of a gradual convergence of the 'financial systems' approach to microfinance (Robinson 2001) with broader development policy based in neo-liberal market ideology (Johnson 2009). The 'modernist' perspective emphasises the importance of institutional frameworks. It sees the government's primary (or for some commentators, only) role as providing a transparent and accountable system of contractual frameworks and property rights which are often approached through the transplantation of what are seen as 'best practice' institutional frameworks from developed countries. It is particularly sceptical of relationships between finance and industry or government, which are seen as being likely to block entrepreneurship and innovation (Honohan and Beck 2007).

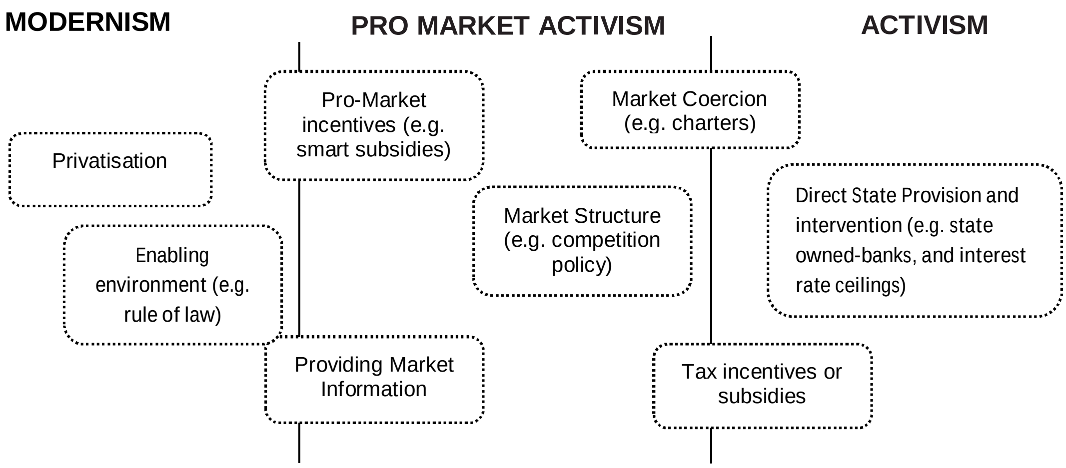
This modernist perspective stands in contrast to earlier activist policies, which emphasised the need to address market failures and use the financial sector to achieve particular development goals. This approach embraced the establishment of specialist development finance institutions (DFIs) and government-owned banks to address failures of the private sector to serve particular constituencies of borrowers such as the agricultural or rural sectors, as well as the subsidisation of credit and interest rates to particular sectors of the economy. Failures of many of these policies to achieve their goals are now widely understood and modernist policy has driven the lifting of interest rate controls, removal of interest-rate subsidies and extensive privatisation of state banks.[3]

However, debates over the role of activist approaches in overall economic development have recently been revisited (Lin 2012). Development policy now increasingly offers an enhanced role for government – coined by De La Torre *et al* (2007) as 'pro-market activism' (see Figure 1 for a graphical stylisation of these three positions). This still places primacy on market mechanisms in allocating resources and would be situated towards the left of Figure 1, but recognises that the state may be best placed to address market development constraints.[4]

[3] See Beck *et al.* (2009) for a more in-depth summary of the evolution in these two positions.

[4] See, for example, the influential Making Markets Work for the Poor (M4P) approach that adopts this middle way (SDC and DFID 2008) through its systemic focus on the three levels of the market (enabling environment, supporting infrastructure and the demand and supply for services).

Figure 1: Perspectives on government roles in the financial sector



Source: Adapted from Napier (2008)

This increased acknowledgement of the potential role for government is reflected in the position taken by CGAP, the leading donor consortium for pro-poor financial provision (CGAP 2006; 2009; and Ehrbect *et al*. 2012; as set out in Box 1 below). It remains close to the modernist position in viewing the state's primary role as setting the enabling environment but it recognises that it may also have a more proactive role in targeting access through specific inclusion-focused policy, legal and regulatory actions. While still firmly against the direct provision of financial services or establishing state owned financial institutions, this emerging approach also opens up some space for governments to accelerate inclusion through short-term subsidies.[5]

While this recognition of the potential role for government involvement is an important opening up of the middle ground, it presents new challenges for those seeking to engage with governments, a necessary step for pursuing a 'financial systems' approach to FI. First, donors are more comfortable with activist approaches when they see them as rooted in strong governance structures, but few countries are seen as actually having 'adequate governance', especially in Africa (Honohan and Beck 2007: 12). Second, governments themselves do not necessarily come to this middle way as a result of compromise and continue to exert strong activist leanings, in part for objectives beyond a narrow inclusion lens. Indeed, there has been a resurgence of activism in general in development strategies, which is likely to grow further in the context of economic crisis (Birdsall and Fukuyama 2011).

[5] See also Meyer (2011) for a review of the evolution and use of subsides for rural and agricultural finance.

Box 1: The role of government in building inclusive financial systems

The role for government as set out by these three CGAP publications are threefold; establishing the appropriate rule regime, promoting financial and market infrastructure and providing policy direction and coherence.

- As a rule maker the government should provide an appropriate and credible enabling environment around who can do what and how. This includes setting up legal and regulatory frameworks to ensure prudential and consumer protection while creating space (and competition dynamics) for transformative models to broaden the financial system, for example allowing banks to use agents in rural areas.

- As a promoter of financial inclusion the government has two roles; first they can provide essential infrastructure such as ID cards (to meet KYC requirements), payment systems, land-titling (to allow easier use of collateral) and public goods such as feeder roads. They can even drive transaction volume through putting their own social payments through the financial system (e.g. using m-banking to deliver pensions).

- The second function is to advocate for financial inclusion through their own strategies and policies (e.g. by setting national financial inclusion/microfinance policies) and coordinate with the private sector (e.g. mechanisms for dialogue that promote information sharing and credibility). There is less consensus on the use of moral suasion (for example pressuring banks to set up basic accounts). While largely credited as a success in the expansion of Mwanzi (basic) accounts in South Africa it has been considered a failure in Uganda where new cooperative institutions were forced to combine with the poorly performing post office system (Beck et al 2009).

- There is also mostly consensus within the donor community about what the government should not do, specifically around resisting the direct provision of financial services through government programmes or state banks. As CGAP (2009) states, "We see engagement of government as direct provider of financial services (especially subsidized credit) as one of the least efficient policy interventions for sustainable access." However, middle-way approaches do suggest a public choice rationale for some short term subsidies, for example incentivising the downscaling of banks into rural areas given the potential positive learning externalities.

In the financial sector, this has included, for example, directed lending in domestic banking sectors as well as directly providing financial services. There are a number of such examples from East Africa – a prominent area for current donor engagement in the financial sector. The Rwanda government, in 2009, set up the Ubudehe Credit Scheme, a directed credit programme, as part of a broader social protection scheme at a capped interest rate of 2% per annum, as well as mandating the establishment of regional savings and credit cooperatives (SACCOs). Similarly in Uganda, the Bona Bagagawale scheme was set up in 2007, including the re-establishment of cooperatives to provide government funds and loans (Goodwin-Groen 2012). In Ethiopia, the government has used the extensive cooperative sector to pursue its wider development policies. Even in Kenya, where the development of the financial sector is seen as exemplary in the region, the government established a Youth Enterprise Fund in 2006 with a majority of the funds allocated to financial institutions with a capped interest rate of 8% per annum, while a minority was directly allocated by district committees at a zero interest rate and a one off management fee of 5%. Countries such as Zambia, Malawi and Tanzania also continue to pursue activist forms of support to enhance access to financial services for small holders through significant input fertiliser programmes. In addition, as social protection schemes – specifically cash transfer programmes – expand and become incorporated into government and financial systems (e.g. through channelling welfare payments through post offices or m-banking), this government footprint is likely to expand further.

A tension, therefore, exists for donors who are pursuing 'market development' or 'financial systems' approaches in contexts with weak governance or dominant activist approaches.[6] This raises the question of how donor policymakers and practitioners recognise and analyse the potential and scope for engagement with government. As a recent World Bank report into Africa's financial sector states; this "requires looking beyond the dichotomy of modernist and activist approaches towards an approach that recognizes that all financial sector policy is *local*" (Beck *et al*. 2011: 227; emphasis added). But as Zhang (2006: 170-1) comments: "the newly found state-friendly discourse has been framed in narrow economic terms…it neglects the political process through which state actors create and regulate the financial system. Despite its emphasis on governance, the paradigm seldom confronts the issue of government and the politics that underlie it". The next section outlines a political economy approach and a governance-engagement framework, as a means of approaching these underlying issues.

3 A political economy approach to donor engagement

A financial systems approach is unlikely to succeed without a broad understanding of the context specific structures and incentives shaping the actions of government and other stakeholders. Under the umbrella term of political economy analysis (PEA), development agencies have invested in frameworks[7] and research analysing such structures and incentives though as yet with little application to the financial sector and FI policy.[8]

PEA clearly seeks to identify the potential hurdles and obstacles to reform, for example, providing a guide as to when not to provide subsidies with the potential for weak accountability mechanisms leading to distortion.[9] It is also intended to guide more positive intervention by development actors through a focus on 'what works' rather than normative ideals of governance (Duncan and Williams 2012). But, a concern has remained, especially with respect to Africa, that the failures of governance make close engagement with government particularly problematic. This position has, however, recently been challenged. Booth (2011: 3) argues, "we should at

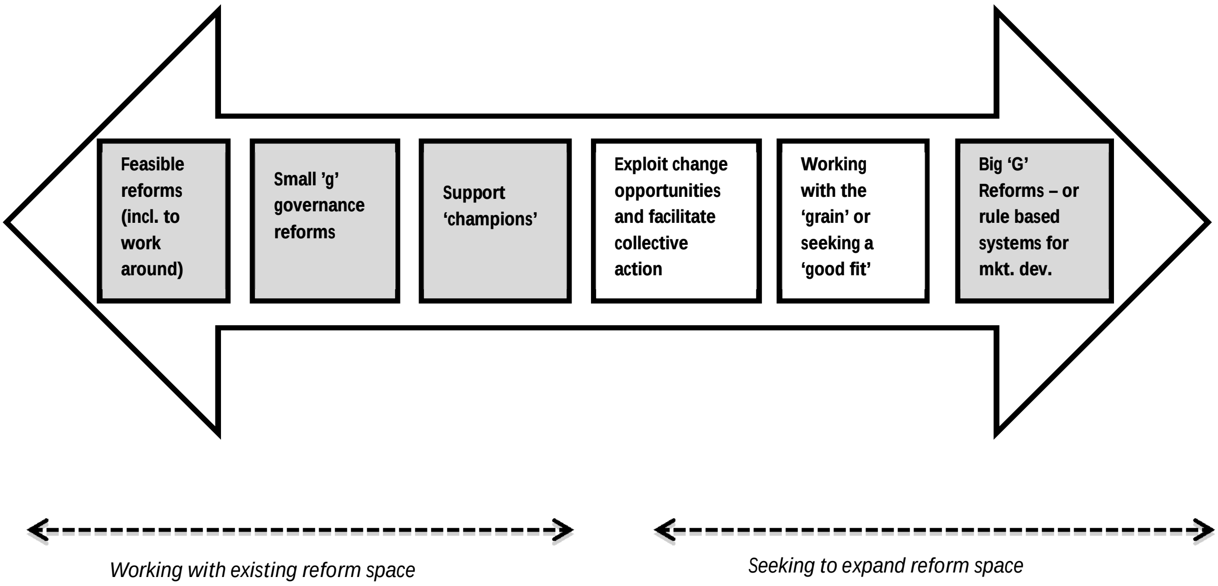
6 An approach that formulates the financial market systems perspective has been developed in particular by DFID, see Ferrand et al, 2004; Ledgerwood 2013.

7 While all donors have slightly different methodologies, they all focus on the interaction between the structural context of reform (i.e. economy, geography, culture); the institutional and governance arrangements in the area in question; and the interests and influence of key stakeholders). This methodology was first set out in the 'Drivers of Change' approach, adopted by DFID, see DFID (2004).

8 Notable exceptions of applying a political economy perspective include Cabello's (2007) PhD thesis, which explored microfinance regulation in Latin America and Dafe's (2011) work on the political underpinnings of financial sector development in low-income countries.

least consider the possibility that there are forms of the neo-patrimonial state that can combine patronage politics with quite a high degree of developmental effectiveness".[10] This has led to the idea of a spectrum of engagement (see Figure 2).[11] This recognises that donors have often wanted to go for large-scale and systemic governance reforms – 'Big-G' reforms – but find significant constraints to their operation. While it is now seen as necessary that demand for such reform comes from domestic constituencies, an alternative strategy is, therefore, to support such stakeholders seeking to create policy change. However this is challenging for donors, requiring working politically and identifying clear 'champions.' Consequently, many donor approaches have tended to revert to the far left end of the spectrum and operate within an existing 'feasible reform space.' This involves a number of options, which ensure that engagement does not directly confront powerful interests. For example, working around government to deliver services through independent or quasi-autonomous entities; or, slightly more ambitiously, engaging with "small 'g'" reforms which seek to build participation in the oversight of public services by interested stakeholders who can build some pressure from the bottom up (i.e. seeking to strengthen civil society). Or, finally, there may be scope at the micro level to support narrow policy reforms that operate in 'islands of excellence' (Levy 2010).

Figure 2: A spectrum of governance engagement



Source: Adapted from Levy 2010 and Booth 2011

Booth's (2011) additions to this spectrum (*shaded in white in Figure 2*) incorporate the potential for more dynamic possibilities for expanding the reform space. He recognises that stakeholder

[10] This is the central thesis of the African Power and Politics Programme, which questions conventional ideas of what constitute 'good governance' in sub-Saharan Africa, see, http://www.institutions-africa.org/ last accessed: 30 May, 2013.

[11] First set out by Levy (2010) and later further developed by Booth (2011).

positions are not fixed and that there may be collective action problems such that there is scope for making 'intelligent interventions,' for example, to support coalition building. Such opportunities are rare given the difficulty of collective action to overcome the status quo, but they may evolve from short or long term shifts in power relationship between public and private actors, requiring practitioners to respond flexibly to exploit opportunities for change. Going beyond this, there is scope for 'working with the grain', which recognises that there may be economic, political, or social institutional factors and arrangements that are not conducive to normative 'Big G' reforms, but rather than trying to replace or work around these there are existing arrangements that can be built on incrementally to work towards desired objectives – in this case, more appropriate financial services.

In bringing these perspectives to bear on FI policy, we can replace the objective of Big 'G' reform with that of 'Big M' market reform to bring about broader and deeper financial systems. An important difference in the case of inclusion is that the 'means' of the market and the 'end' of inclusion have greater scope for separability than in the case of governance, in which good governance is both ends and means. Hence, the goal of inclusion may have more routes to its achievement than those that are solely market based. If the objectives of achieving the end of 'Big M' markets are not sacrosanct, it opens up space for moving across the central space of Figure 1 and expands opportunities for engagement by donors, moving towards FI policy that fits.

The starting point for analysis, therefore, is to understand the political economy constraints to achieving market-led FI. The next section addresses this in two parts by asking: [12]

1. How the financial sector is influenced by the wider system of rent allocation and its role in the economy as a whole? and
2. The way rules within the financial sector are influenced by local political and social dynamics, and what this means for policy processes?

The final section of the paper will then discuss where donor interventions in the financial sector currently fit on the governance spectrum and what challenges this analysis offers for supporters of FI policies to do more to work with the grain.

4 The political economy of financial inclusion

4.1 Structural factors: The political economy of the financial sector

A broad political economy perspective considers how the financial sector fits into the overall structure of politics and the economy. It considers how individuals and groups compete for power by investing in activities that uphold their survival (Whitfield and Therkildsen 2011). A rational choice perspective along these lines is illustrated by Bates (1986), who describes how urban bias policies of African governments in the 1980s responded to coalitions of urban elites and farmers, with the financial sector being structured to channel rents to these groups, for example, through subsidised credit. This fits closely with a modernist perspective that argues

[12] The interplay between these three categories follows the Drivers of Change (2005) concept developed by DFID and incorporated in most subsequent PEA frameworks thereafter.

that the financial sector is distorted by groups for personal gain, and, therefore, the influence of such groups (i.e. the state) should be limited.

Another central tenet is that bargaining and contestation between groups seeking survival dictates policy outcomes including how rents – defined as an excess of income over the market alternative (Khan and Jomo 2000) – are allocated. A rent distribution perspective provides an alternative logic to the view that the financial sector is simply corrupted and used for personalised aggrandisement and instead recognises the use of redistribution to provide stability along with the deep-rooted social structures underpinning it. North *et al*. (2007: 1) argue, "political elites divide up control of the economy, each getting some share of the rents…adequate stability of the rents and thus of the social order requires limiting access and competition-hence a social order with a fundamentally different logic." For example, significant input and post-harvest finance in Zambia, to which over 60 per cent of the Ministry of Agriculture's funding is allocated (Nicole *et al.* 2011), is consistently derided by donors for its deep inefficiencies (i.e. a lack targeting, price distortion in input and output markets and overall fiscal cost). However, viewing this in terms of market development alone ignores the wider importance of this allocation of resources in connecting the state to rural elites and voters and across ethnic lines.

These patterns can often endure for a long time as vested interests and social norms mould the institutional framework to continue the status quo. For example, FICCI/M-Cril (2011) argue that in India a 'rights' perspective has emerged around the subsidisation of credit for the rural poor partly based on a postcolonial state building process of rent distribution to rural areas. A consequence of this is that even when formal rules create a low regulatory burden for banks to commit to the lower end of the market they are discouraged by the belief that broader obligations will be placed on them. Moreover, the recent microfinance crisis in Andhra Pradesh (CGAP 2010) can be better understood within these dynamics. It exemplifies the case where politicians were keen to ensure their continued role in credit provision to rural voters through government programmes linked to Self-Help Groups in the face of competition from independent microfinance institutions. As a result they used their power to rein in the industry and used arguments that MFIs were charging excessive interest rates and over-lending to encourage borrowers not to repay MFIs so plunging them into crisis.

In the African context, such systems of resource allocation have been analysed as neo-patrimonialism, where authority structures are based on personal relations and tied to the distribution of resources. Private good provision, such as subsidised credit or the writing off of debts, is a more effective tool for ensuring support than relying on the public provision of services or redistribution of domestic revenue, which tend to be weak (Khan 2005). The prevailing view is that these features constrain the potential for reform in the financial sector in Africa, especially when exacerbated by ethnic fractionalisation and mineral dependence (Beck *et al*. 2011). However, recent analysis argues that countries in Africa that have managed to achieve development outcomes in the context of neo-patrimonialism have demonstrated the ability to "coordinate between 'good' and 'bad' rents by balancing the demands of politically strategic groups for hand-outs, …with the hand-ups required by genuine entrepreneurs" (Kelsell 2011: 78). The ability to do this depends on a number of conditions. First, elites need long-term time horizons emanating from the strength of their coalitions vis-à-vis opponents (or a lack of groups to buy-off). Second, the nature of political competition affects time horizons. Third, the extent to which rent management is centralised (often associated with personalised leadership). Fourth, the incentives to broaden the tax base and, therefore, private sector (or limited access to easy rents such as natural resources), and finally, a disciplined and competent bureaucracy.[13]

The above suggests important constraints to building inclusive financial systems based on building markets intended to produce competition and innovation. The state is the creator of market structures through the extent and degree of regulation, and increased competition between actors and interest groups may be viewed by elites as a source of instability and threat to the social order.[14] This, therefore, directs attention to the relationships underlying the structure and operations of the financial sector as powerful interest groups are able to shape the speed and nature of change (Rajan and Zingales 2003). Variations in the state's relations with private capital are often clearly reflected in the structure of the banking sector and work through into the nature of banking sector reform and its outcomes reproducing political economy structures and diminishing the impact of banking reforms (Boone 2005). Even if 'best practice' rules are put in place, their implementation may be influenced by political forces. For example, attempts to ensure the enforcement of existing regulatory or supervisory rules may be resisted due to inside pressure towards regulatory forbearance (Brownbridge *et al.* 2002). Inclusion objectives have added an extra layer of complexity to this interest group perspective with new trade-offs, for example, between growth and stability objectives for elites, the private sector and regulators (Porteous 2006).[15] For example, recent developments in technology and the potential for mobile banking to address inclusion have led to the respective power and interest of banks vis-à-vis telecommunications companies and their interactions with regulators becoming more prominent.

Two main structural factors in the relationship between the state and the private sector – and especially banks – have been highlighted as affecting the efficacy of an activist approach (Dafe 2011). These, in part, correspond to the characteristics set out above that separate good rent management from bad.[16] First, is the degree of autonomy of the private sector and specifically banks from government, and, second, is the degree of concentration of the private sector and again banks in particular. Autonomy of the private sector from the government leads to greater structural dependence of the state on it and increases the chances of coalitions across the divide to enhance financial sector development, while low concentration reduces the potential for their political capture. This reflects a fundamental tension for the financial sector; governments regulate, supervise and discipline financial intermediaries but rely on the same intermediaries as

[13] See work by the African Politics Programmes and Moore (2007) for specific links between taxation and state building. As well as these aspects Williams *et al*. (2008) argue that attitudes towards business and public expectations for public officials also play a role in reducing rent seeking.

[14] Beck *et al.* (2011) highlight that this may be particularly true in SSA, when short election cycles create a further imperative on limiting competition.

[15] For example, central banks now in some countries have the duel mandate of both promoting inclusion as well as maintaining overall financial stability.

[16] This draws inspiration from the East Asian development experience and the work of Evans (1995) and Khan and Jomo (2000).

a source of public finance from taxation and borrowing as well as for a channel for ensuring votes and political support (see Calamoris and Haber 2011, cited in Lin 2012).

Whilst this perspective on coalitions has important implications for financial sector development and therefore – if broad based – for FI, it also applies to more direct inclusion dynamics. For example, Cabello (2007), in a study on microfinance development in El Salvador, Honduras, and Guatemala, illustrates how the state's lack of dependence on the rural private sector reflected its easy access to overseas remittances. These, in turn, originated from the under-development of those rural areas, and then reduced the incentives for policymakers to promote the industry as support to the rural sector. Patterns such as these are frequently found – as also, for example, in the case of Zambia and state-dependence on the mining sector. Political autonomy though does not necessarily prevent moves to create broader markets. Public actors playing the stronger role in coalitions at certain points in time are able to hold sway over financial institutions for example by pressuring commercial banks to give up their monopoly control of the payment systems, such as in South Africa. However, the extent of autonomy between groups making up coalitions may be difficult to establish (particularly for external actors) given that inter-relations between the state and private sector frequently operate through the influence of elites and their social networks. To some extent they are often indistinguishable. In this context, efforts to institutionalise practices such as credit registries in a bid to overcome what are seen to be market information asymmetries may be resisted as they may cut off access to resources through such networks (Beck *et al*. 2011).

4.2 Institutions and financial inclusion

Moving from the wider structural political economy view, we can examine more specifically the institutional dynamics of the financial sector. A focus on institutions has become central to recent understanding of both developing the financial system as well as wider development policy (Demirgüç-Kunt *et al.* 2008). Institutions, that is, how rules – both formal rules such as policies, laws, regulations and informal norms, conventions, conduct and traditions – all come together to influence the performance of the sector.[17] Development policymakers and practitioners increasingly focus on institutional reform as a means to market development. But this is often approached in a technocratic manner with the main focus on how reform can lower the risks and costs to market development. A political economy perspective brings in the political, historic and social dynamics that underpin these institutional arrangements and therefore provides a more realistic approach to engaging with them.

Institutional reform as a means to market development often involves a focus on the creation or adjustment of formal rules, for example a new microfinance or FI policy. These can be relatively easy to create or change, but they often do not 'stick' and are left unimplemented when they do not fit with the underlying institutional environment (Boettke *et al*. 2008). Moreover, the emphasis is often on the *form* of institutions rather than the *functions* that they achieve (Chang 2006; Goodwin-Groen 2012). This focus has been evident in many attempts to transplant what are seen as 'best practice' regulatory forms into developing countries but which fail precisely because they take insufficient account of the underlying social, cultural as well as political

[17] This focus also recognises that hands-off approach to market development is not possible. As Polanyi (1944) has argued extensively, markets are always constructed through political and social means.

institutions – both formal and informal (Chang 2006; Rodrik 2007; 2008). For example, Goodwin-Groen (2012) shows how the Microfinance Act in Uganda built on indigenous norms of small-scale saving by legitimising deposit taking and allowing their intermediation. But she recounts how when the Regulations to go with the Act were developed by the Central Bank, this aspect was directly undermined by only allowing the use of savings as cash collateral for loans. This resulted from risk adverse regulations viewed as global best practice by technical advisors.[18]

The implications of interest groups role in the regulatory and supervisory structure has been pointed out above but this is also part of an overall institutional environment that is historically determined as well as being part of a complex political equilibrium (Fergusson 2006: 61). For example some commentators have pointed to the role of political institutions in limiting the worst kinds of capture (Haber *et al.* 2003). However, the links between democratic accountability and FI are not clear-cut. There is the classic collective action problem of numerous but diffuse winners from inclusion (namely the poor) bargaining against concentrated and more powerful losers (be it banks or elites).[19] A greater concern perhaps for a market development approach to FI, is that rather than reining in opportunism, in youthful democratic regimes with short-term election cycles such as in SSA, financial intermediaries become the key vehicle to buy support (Girma and Shortland 2005, cited in Milo 2007).

Institutional analysis in particular highlights the 'path-dependence' of institutional change. For example, the 'law and finance' perspective argues that the level of legal protection and quality of law enforcement is determined by a country's legal system origins, with common law systems providing better protection for investors through stronger contract and property rights than civil law legal systems (La Porta *et al.* 1998).[20] Importantly, in terms of the dynamic landscape of FI it is argued that common law legal systems adapt more easily to changing economic and commercial needs so providing greater flexibility. This has been argued to be a constraint to the development of mobile banking in Latin America in contrast to South Africa and Kenya (BFA 2009). But on the other hand, civil law systems may lead to more rapid development once laws are adopted as, for example, in the case of correspondent banking in Mexico (*ibid*).

Formal rules and structures are underpinned by informal norms, conventions and practices as well as mental models, ideologies and beliefs (Williamson 2000; North 1990). To some extent, FI policy is further advanced in recognising these than many other development areas. For example, trust and social networks are well recognised and considered particularly important in weak institutional environments where more formal rules such as debt creditor rights, property rights and collateral laws are absent. These are often seen at a micro level where information

[18] This corresponds to Rodrik's (2008) finding in Vietnam that the focus on strengthening formal court systems risked undermining the strong functioning relationship contracting that existed (as well as being costly in terms of learning and bargaining that the creation of new institutions entail).

[19] A caveat to this is that as countries move to a financial systems approach which includes "all" unbanked (i.e. not just the poor) the constituency for enhanced inclusion may improve by including emerging middle classes as well as small and medium enterprises (Rajan 2006, cited in Demirgüç-Kunt and Levine 2008).

[20] Another path dependent explanation is Acemoglu *et al.*'s (2001) argument that secure property rights were based on the incentive structure to develop long term institutions which were determined by the ability for colonial settles to resist disease and a lack of extractive resources.

flowing through these relationships reduces the costs of screening and enforcement (Armendáriz and Morduch 2005). Allen *et al.* (2007) found that in India, non-legal 'institutional substitutes' such as reputation and personal relationships were a more effective means for screening and contract enforcement than more formal institutions such as creditor rights. But they are also seen at a broader level. For example, relationship lending is strong throughout SSA with reputational networks built around culturally connected groups (Honohan and Beck 2007). As they ask in relation to SME lending in Africa, "by limiting themselves to financing the large and collateralized borrowers [and ignoring such networks], could banks be missing out on a lucrative market?" (Ibid: 149). This may be particularly important where banking systems dominate (over market systems) and little credit information exists allowing the harnessing of local 'soft' information through long term relationships (Lin 2012).

However, social relations also create systematic reasons for exclusion in particular through the discriminatory impact they have. Social relations such as those of gender, ethnicity and caste have long been argued to lead to markets being fragmented and socially regulated (Johnson forthcoming). For example, the impact of gendered social relations on FI through the operation of property rights is extensively evidenced (Johnson 2004). From a different angle, Ansoms (2008) has argued that cultural perceptions in Rwanda of the poor, emanating from the historic split between urban elites and rural peasantry, create perceptions of the poor as welfare recipients with the wrong 'mentality'. This in turn may influence the current emphasis on supply side FI programmes based on credit and the 'sensitisation' of the poor, as opposed to more demand led products.

A caveat to the above emphasis on historic and social dynamics is that that they leave little room for the understanding of how individual agents or groups can shape as well as be constrained by their institutional context (North 1990). Stakeholders may have a significant influence in pushing for or subverting specific forms of policy, with history showing that 'champions' have pushed for changes that fall outside of what the institutional environment might predict. For example, recent progress in FI in Pakistan is argued to be partly a result of the then Governor of the Central Bank successfully advocating for a new FI unit with the Bank, thus, bypassing more conservative stakeholders in the government.[21] Similarly a focus on context also ignores the overlap between this and the 'content' of policy including the reactions to and the capacity to implement (Grindle and Thomas 1991). This paper, while acknowledging that these areas are crucial components to the political economy of policymaking and a central part of PEA approaches in other sectors will not dwell on them further. They transcend the focus on FI and are present in most development policymaking, with practitioners correspondingly more aware of their dynamics.

5 Finding space for engagement

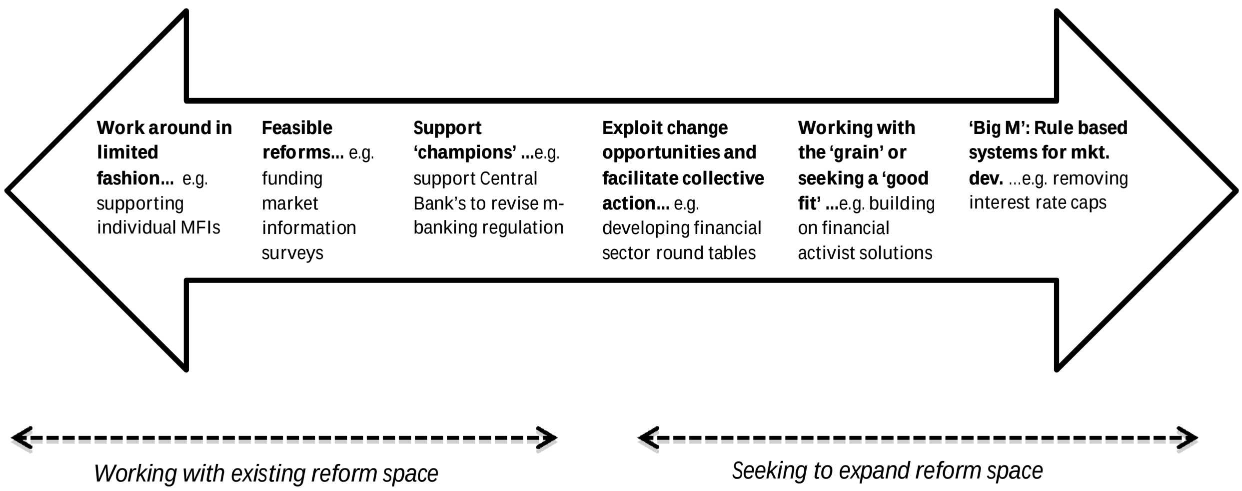
The previous section has identified the underlying constraints that a political economy perspective highlights for FI through market-based financial sector development. With this in mind we can now consider the options for engagement in the context of pro-market activist approaches and the spectrum of strategies for governance reforms presented in Figure 2 to

[21] This was based on interviews with financial sector practitioners working in Pakistan during this period.

arrive at Figure 3. In doing so, we find that donor policy towards FI – originating largely in microfinance – has broadly evolved along this spectrum over the last 30 years, towards the current need to consider how to engage on the basis of more pro-market activist approaches.

The following section will then identify the potential for more ambitious and challenging approaches to FI policy that entail 'working with the grain' and the considerations that underlie these. This requires considering the relationship between means and ends. As discussed above, to date the development of the financial sector is primarily seen as being achieved through the means of Big M market development, which will bring about broader and deeper financial systems. However, if inclusion itself is the goal then it is clear that there may be more routes to inclusion than those that are solely market based. Indeed, the low outreach trap in Africa has been the result not necessarily of a lack of competition among banks for those customers who banks recognised as their market but a failure to innovate or seek economies of scale that could render the majority rather than the minority of the population bankable. Alternative routes such as the threat of legislative pressure leading to the design of a basic bank account in South Africa (see below) or currently in Namibia[22] may, therefore, be legitimate interventions.

Figure 3: A spectrum of engagement for financial inclusion policy



Source: Adapted from Levy 2010 /Booth 2011

5.1 Risk-averse approaches to engaging government

5.1.1 Big 'M' approaches.

Early modernist policy for the financial sector primarily sought what we term 'Big M' market reforms through liberalisation and privatisation. These pursued a normative view of the governance arrangements needed for market development characterised by strong rule based systems of property rights robust competitive practices, well-functioning credit registries a pro-active but limited state and so on. As highlighted in section 4, such reforms are often not

[22] See http://namibiansun.com/content/business/low-cost-bank-accounts-for-low-income-earners, last accessed: 30 May, 2013.

feasible because they encounter alternative modes of resource allocation, vested interests and institutional or policy constraints. Despite this, big 'M' objectives still underpin much technical donor assistance.[23] Where they are tried they often seek to transplant what are considered 'best practice' institutions which in turn fail because they do not 'stick' given the underlying structural and institutional context (Beck *et al.* 2011; Boettke *et al*. 2008). For example, a recent review of a number of national microfinance polices concluded that key weaknesses emerged from them being donor driven with a reliance on 'templates' that fail to reflect local realities (Duflos and Glisovic-Mezieres 2008).

5.1.2 Working around government

While some reforms that fit into this Big M category has been achieved (Demirgüç-Kunt *et al*. 2008), many difficulties and failures arose and policy in some domains initially bounced to the opposite end of the spectrum: either complete disengagement from the financial sector or working around government. This was very much evident in the context of Bangladesh in the 1980s when donor support shifted from government to NGOs in the wake of structural adjustment policy (Devine 1999; Wood 1997) and led to the approach of building independent microfinance institutions initially based in NGO development programmes. More recently, a number of major donors disengaged from supporting the microfinance sector in Uganda partly in the context of strong government activist policy towards the use of the SACCO sector for FI (Goodwin-Groen 2012).

5.1.3 Promoting 'limited' reform in financial systems

The shift to the financial systems approach saw donors seek more market-based reforms while continuing to work around the state. This included the development of microcredit schemes based on cost covering interest rates in the NGO sector and eventually also direct support to private sector financial institutions (including banks). However, as this approach has itself evolved it has required ever-greater engagement with government – for example, in the need to develop microfinance legislation to adequately regulate and supervise an emerging sector. As section 4 illustrates, this situates practitioners in a messier position where working with coalitions of governments and private actors may be risky. The following sets out some granular options in mitigating these risks through identifying a feasible, albeit more limited reform space since scale is compromised and opportunities to be more responsive may be missed. This, it could be argued, characterise much of where current donor strategies operate.

In those areas that do present risk, it may still be possible to achieve non-threatening market development reforms, building credibility along the way by not fully confronting or shifting activist models. There are a number of potential reforms at a macro level that require relatively little political buy-in but still go some way to building market institutions. For example, development agencies working with regulators on improving market information through standard setting bodies such as Basel and the Financial Action Task Force. Certain regulatory and legal reforms may also be somewhat insulated from the political economy dynamics, remaining largely focused on more technical processes – for example, the processes of setting up payment systems (although even then any discussion around interoperability is likely to be affected by

[23] See Copestake and Williams (2011) for a review of some of the incentives behind this, and why donors struggle to take a more political approach.

conflicting interests, for example of large and small service providers). Subsidies to the financial sector can also be provided using market inducing modalities outside of direct government participation.[24] Indeed, challenge funds, such as the one that supported the development of Safaricom's M-PESA product in Kenya, are an increasingly popular way to use fiscal resources to stimulate market innovation. Similarly, credit guarantee schemes perhaps the archetypal pro-market activist intervention in that in that they marry fiscal resources to overcome market externalities (for example, asymmetric information in regard to SMEs previous performance) with market discipline. Incremental reforms to government activist programmes may also occur. For example, IFAD in Zambia currently work through the government development bank to support banks and other FIs to develop more appropriate and affordable products. Such support is frequently designed to support market competition through a challenge fund arrangement (IFAD 2004).

More proactive approaches may include identifying (e.g. through stakeholder analysis) existing champions or coalitions for reform with the role of the practitioner being to inject information and evidence to key actors, for example through highlighting key demonstration models or regulatory approaches in different countries.[25] It may also include establishing mechanisms to allow collective action, such as setting up coordination mechanisms – for example FI working groups or 'roundtables'[26] – between like-minded groups such as the Ministry of Finance, the private sector and other members of the development community. This coordination function is crucial given the differing capacities, mandates and objectives of those involved in FI (BFA 2009). For example, there are often trade-offs between a Ministry of Finance seeking medium term growth with that of other ministries, who may primarily be concerned with shorter-term livelihood or welfare issues. It may also require identifying and engaging with opposition groups who need convincing of the benefits of a more market-oriented approach, including perhaps how it may fulfil, or not interfere with, certain rent allocation functions, at least in the short term. For example the benefits that better governance of state financial institutions may bring, including new resources and legitimacy from donors (or new rents) and further funds to direct to key sectors may be achieved alongside activist development strategies.

The framework presented in Figure 3, therefore, provides a useful way of thinking about the response of donors to engaging with governments on achieving broad financial sector development, which is, pursuing a more limited but less risky approach that avoids the deep political economy dynamics. The extent to which this approach is based on an explicit political economy judgement by donors rather than being their default risk-averse starting position is likely to vary. However, it corresponds to section 4's analysis by recognising that governments may be reluctant to leave space for more long term market driven approaches given their desire to maintain stability, and instead pursue more direct activist development strategies, which offer more short term (and visible) opportunities for gain. This is also in line with a recent World Bank report into Africa's FI landscape, which argues that first, practitioners need to, "seek out

[24] For example, special purpose vehicles with separate organisations to administrate them.

[25] At a broader level this is a key role for organisations such as CGAP and the peer group Alliance Financial Inclusion (AFI).

[26] These have been particularly prevalent in Latin America.

incremental reform options that are feasible given political economy realities"; second, to do this with optimal policies in mind; and third, to see how institutions may be strengthened (Beck *et al*. 2011:232). The next section discusses what a more pro-active engagement would look like.

5.2 Embracing risk and 'going with the grain'

5.2.1 A responsive approach to building systems

In the context of Booth's additions to the spectrum as set out in section 3, one approach to building more ambitious and dynamic approaches to market development has been the multi-donor Financial Sector Deepening (FSD) Trusts in Africa. These have been designed to work directly with private sector institutions as well as with government to address constraints to FI. In a way, they, therefore, operate simultaneously at different points on this spectrum in Figure 2 by seeking to build retail capacity and competition at the micro level while developing support services at the meso level and addressing the institutional regulatory and supervisory environment at the macro level. By building a presence as a supportive and engaged player in the sector over the longer term, this has enabled trusts such as FSD Kenya to assist at strategic moments by providing inputs into decision making – for example in providing technical advice to the Central Bank to allow the development of Safaricom's M-Pesa product and approach it with a light regulatory touch (Stone *et al*. 2010). Another example is the case of South Africa where the introduction of the 'Mzansi' basic bank account, at the behest of the regulators, was a response to a change in the political economy. In this case, it was a means to satisfy the government's need for the retail financial sector to respond to the black empowerment agenda, with the FinMark Trust helping supply market information for the retail sector to respond to this challenge (Porteous 2004).

5.2.2 Accepting risk and working with the grain of activist solutions

But, there is another step on the spectrum towards 'working with the grain' that more directly considers what local economic, political, or social structures and incentives could be worked with to achieve FI. This recognises that FI as an end can be achieved through multiple routes and not solely through competitive market provision based on strong rule based frameworks. Dafe (2011) to some extent moves in this direction with the suggestion that an optimum mix of banking autonomy and concentration may create governance dynamics that are more conducive to activist approaches. This would imply a banking sector that is strong enough vis-à-vis government with the motivation to push for reform while being diverse enough so that concentrated interests do not distort and capture this process. However, within this framework such activist interventions are considered to be 'time-bound', largely consistent with more orthodox public choice justifications for pro-market activism that still fits firmly within the desire for big 'M' solutions. For example, short term subsidies to correct the negative externality of the under provision of financial innovation in the financial sector resulting from the difficulties of protecting rents accrued. Indeed, Dafe suggests that if such conditions are judged unfavourable then one option is to engage with 'second best' institutions such as building on relationship lending. Whilst this paper would agree with the premise of relationship lending as one example of building on local structures, the identification that these are 'second best' highlights that normative 'first best' big 'M' are still considered the end game. A re-examination of the means and ends of FI provides greater scope to move across the central space of Figure 1 towards FI policy that fits.

The African Power and Politics Programme (APPP)[27] promotes a broader framework than Dafe's (2011), as discussed in section 4. The conclusions of this programme for 'working with the grain' in governance reforms highlight that even where governance structures are far from the norm, development outcomes have occurred where an interplay of factors are present. These include where rents are centrally controlled through political leadership, long-term horizons are manifest (based on a national vision as well as the need to use rents for productive purposes) and bureaucracies are disciplined and pressured to perform.

For practitioners to work with the grain is challenging. Information on the exact political economy dynamics is nearly always incomplete and incentives for more recognisable and risk averse strategies persist. But incremental options also exist. For example, this may include working directly with state banks or directed credit schemes to improve their performance, whilst bearing in mind that what constitutes 'success' is likely to go beyond the crowding in of private actors, and include objectives of targeting specific groups consistent with a government's wider development strategy. An example is the use of external management contracts used with Tanzanian and Mongolian state-owned banks to turn their operations around as a strategy to 'work with rather than around' the government and maintain the strengths of the networks that already existed (Dressen *et al*. 2002).[28] A more explicit approach would be to build on broader activist approaches to FI because they are not only the politically feasible option but also that there might be additional advantages when implemented appropriately. For example, the presence in rural areas of government institutions provides important infrastructure and government may be more expected and accepted as a local player. A recent systematic study into formal access, albeit from a small selection of studies focused on India, concluded that, "state-led expansion of the banking sector in rural areas can reduce rural poverty, increase rural wages and increase agricultural investment" (Pande *et al.* 2012: 1).

It is possible to envisage more radical options. While working with cash-transfer schemes to deliver FI offers one route that is now accepted by donors as a means to develop financial service infrastructure in remote and rural areas (OPM 2008), it is possible to go further, for example, and work with existing subsidy schemes but find ways to allocate them with moves to FI in mind. For example, as in Zambia, delivering and managing input subsidies, through e-vouchers delivered to mobile phones.[29]

This approach is reflected in Indonesian National Program for Community Empowerment (PNPM Mandiri) which is the government's main community-driven development program for poverty alleviation and has been supported by the World Bank, EU and a number of other bilateral donors. The programme gives grants to communities to invest in their own projects to achieve employment generation and small-scale infrastructure development. The origins and design of

[27] See http://www.institutions-africa.org/, last accessed: 30 May 2013.

[28] Both were later sold off to overseas investors.

[29] See http://www.scidev.net/en/news/zambia-scales-up-agriculture-e-voucher-scheme.html, last accessed: 30 May, 2013.

this programme in itself are deeply embedded in the political economy of rural development in Indonesia (Bebbington *et al*. 2006). Many communities have set up revolving loan funds (RLF) to offer credit for small scale enterprises at locally determined interest rates (which have average percentage rates in line with microfinance practice). These RLFs have produced very good outreach (3,300 RLFs reaching approximately 1.5m borrowers), but poor returns which also tend to deteriorate over time (Micro-Credit Ratings International Ltd, 2012). Nevertheless, this programme acts as a bridge between two areas of the Government's national poverty reduction strategy: Cluster 2 - community empowerment, and Cluster 3 - access to finance for the poor and for private sector development through its potential to leverage debt from commercial banks for the benefit of Indonesia's poorer communities (PNPM Support Facility, no date). A phase of capacity building is therefore underway to develop their management and make them more sustainable so offering a route to financial service access linked to private sector delivery.

An even more radical approach may include providing longer-term subsidies that are not strictly 'smart'[30] – or designed purely to right the market – but given underlying conditions are able to create new opportunities within the existing environment for the entry of new private sector providers.

Moreover, it is often the case that interventions operate in an on-going way and with smaller spaces for opportunities where decisions as to feasibility are made within the framework of wider programmes. In other words, choices of when to 'work with the grain' do not only occur at this macro political economy level. Donor engagement often ebbs and flows with donor assistance trends as well as the difficulties of operating in a particular sector, therefore decisions about programme design and options operate within cycles of engagement on a more micro basis. Consequently, the wider political economy focus of this paper will need to be augmented with assessing space for engagement through informed and reflexive PEA that cuts through this to the specific factors affecting particular programmes (see Copestake and Williams 2012).

6 Conclusion

This paper has explored the tension that exists between financial inclusion policy founded in market modernism, and the need to engage with governments with more activist leanings and weaker governance capabilities in order to achieve this. It has demonstrated the insights that a political economy perspective can offer by revealing the underlying dynamics at play.

We have argued that there are opportunities for a finer grained understanding of the space for engagement and arising from this that there are approaches to donor engagement, which may push the envelope of strategies. In particular, the 'end' of inclusion may be achieved by a variety of means that go beyond the current orthodoxy for 'Big M' market development and clear rationales for subsidy driven from a public choice perspective.

To 'work with the grain' is to understand the conditions under which activist governments are more likely to achieve developmental outcomes rather than to assume they cannot. We further argue that donors may need to be prepared to take greater risks once they engage with these deeper understandings. Moreover, the appetite for such risks can sometimes grow from the successful implementation of smaller scale initiatives within 'small M' reforms. Additionally,

[30] See Meyer (2011) for what constitutes a 'smart' subsidy.

thought can be given to adopting approaches that build on local social institutions, which may abandon what are externally perceived as 'best practice' approaches, but solve particular problems of provision.

This means that practitioners should 'pause' before immediately attempting to strengthen more formal institutional processes (Rodrik 2008) or adopt best practice institutional change, as this is unlikely to 'stick' if not adequately embedded into broader political and social relationships. A solid understanding of local institutions and incentives is a pre-requisite for sensitive and successful engagement and developing the space for inclusion opportunities requires reflexivity on the part of the practitioner – be they development agency, consultant or government official.

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