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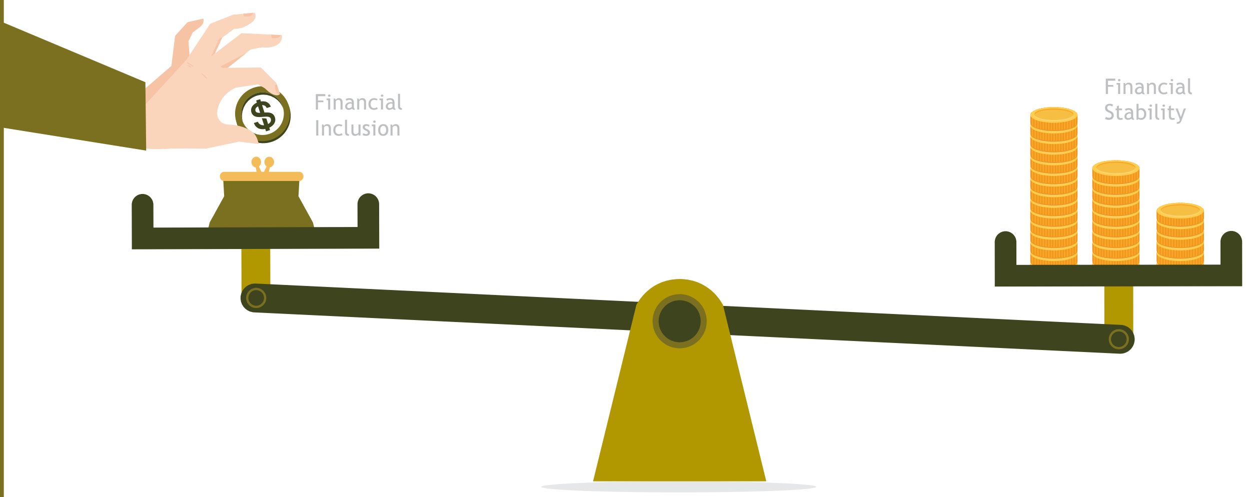
Managing the Twin Responsibilities of Financial Inclusion and Financial Stability



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afi Viewpoints

AFI Viewpoints is an occasional publication for high-level policymakers from the AFI Network to express their opinions on current financial inclusion policy issues.

ABSTRACT

The global financial crisis of 2008 proved that sound macroeconomic policies, low inflation and low or no budget deficits do not necessarily create economies that can weather financial instability. Surveys conducted after the financial crisis have shown that economies with resilient financial sectors and high economic growth are also no guarantee of balanced and inclusive growth. This has become all too clear in times of disaster, such as Typhoon Haiyan in the Philippines, when the poorest and most vulnerable were still not protected by a stable national economy.

In these times of financial, economic and social crisis, policymakers have recognized the powerful links between macroeconomic stability, financial stability and financial inclusion in achieving balanced and inclusive economic growth. As economies recover from the global recession, the need to harmonize financial inclusion and financial stability objectives has become even more pronounced. The concept of financial stability is gaining traction in the macroeconomic frameworks and policies of both developing and developed countries, and leaders and policymakers are making public, high-profile commitments to financial inclusion through initiatives such as AFI's Maya Declaration.

This AFI Viewpoint, "Managing the Twin Responsibilities of Financial Inclusion and Financial Stability", reflects on country experiences and trends in this area at both global and national levels. Although the paper shares the experiences of particular countries and studies, the objective is not to propose a 'one size fits all' model or recommend a single approach. Rather, the aim is to reflect on a range of approaches and perspectives.

INTRODUCTION

The changing global economy has left leaders and policymakers wondering what will come next. Although the West led economic growth in the 20th century, the 2008 global financial crisis and 2010 eurozone crisis pushed its financial system to fatigue. The majority of Western economies are now grappling with low growth, high unemployment and austerity measures designed to address unsustainable budget deficits. Meanwhile, Asia is being called the world's economic growth engine, but this growth has not been inclusive. High levels of poverty persist, which could be socially explosive and threaten the sustainability of the region's growth.

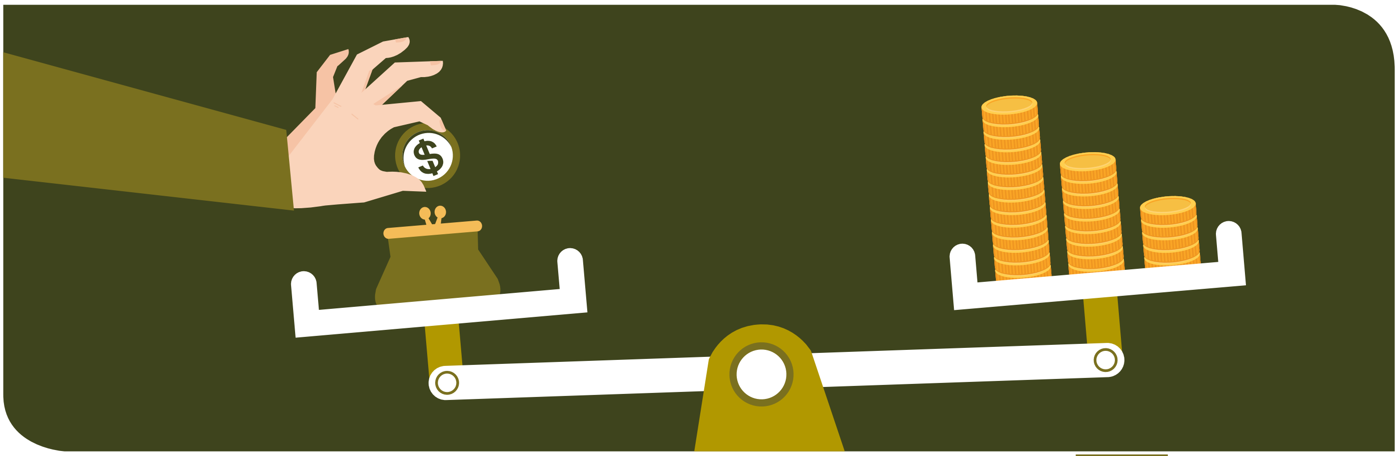
As a result, leaders and policymakers are recognizing that financial inclusion is key to accelerating inclusive and sustainable economic growth. G20 leaders endorsed it as a key pillar of the global development agenda in 2010, and since then, groups such as the Global Partnership for Financial Inclusion (GPFI) have engaged with international standard-setting bodies to implement global standards in line with the financial inclusion objectives of national policymakers. Over 59 countries have made concrete, time-bound commitments under the Maya Declaration[1] (launched at the AFI Global Policy Forum in 2011) to advance financial inclusion in their own jurisdictions.

However, well-defined financial policies must pursue four core objectives simultaneously: financial stability, financial inclusion, financial integrity and consumer protection. In collaboration with financial policymakers, the Consultative Group to Assist the Poor (CGAP) has developed the I-SIP methodology (Inclusion, Stability, Integrity, Protection)[2] that enables policymakers to understand and optimize the linkages between these policy objectives while at the same time minimizing trade-offs.

This AFI Viewpoint focuses on the relationship between financial inclusion (FI) and financial stability (FS) specifically, and how financial policymakers can manage these dual responsibilities most effectively.

"Well-defined financial policies must pursue four core objectives simultaneously: financial stability, financial inclusion, financial integrity and consumer protection."

[1] See http://www.afi-global.org/maya-declaration
[2] See http://www.cgap.org



What is financial inclusion (FI)?

The definition of financial inclusion (FI) varies from country to country depending on national objectives, but it is commonly understood as a way to provide financial services to those who do not have them. FI embraces three core elements: access, usage and quality of financial services. The GPFI has defined FI as "a state in which all working age adults have effective access to credit, savings, payments, and insurance from formal service providers."[3]

Financial inclusion allows the unbanked and underbanked segments of society to join the formal financial system, which ultimately helps to alleviate poverty, promote job security, security and improve livelihoods and advance social empowerment.

What is financial stability (FS)?

The South African Reserve Bank has defined financial stability as the smooth operation of a system of financial intermediation between households, firms and the government through a range of financial institutions. FI and FS are not ends in themselves, but rather facilitate sustainable and balanced economic growth.

Various research studies and surveys[4] have shown that financial inclusion plays an important role in achieving financial stability if policymakers can effectively apply the principle of proportionality, which balances risks and benefits against the costs of regulation and supervision while maximizing results. The South African Reserve Bank has supported this approach with seven guidance statements,[5] and the State Bank of Pakistan has offered six I-SIP propositions[6] that ease the design and implementation of policy interventions by identifying, managing and optimizing the linkages among financial inclusion, financial stability, financial integrity and consumer protection.

Complementary linkages between FI and FS

In a CGAP brief, the four objectives of I-SIP are described as "inter-related and, under the right conditions, positively related. Yet failings on one dimension are likely to lead to problems on others."[7] The International Association of Insurance Supervisors (IAIS) reinforces this idea: "Financial inclusion contributes to financial stability. It is an important element in delivering fair, safe and stable financial markets in a jurisdiction."[8]

[3] 2011 GPFI white paper
[4] GPFI white paper 2011, CGAP website
[5] CGAP South Africa I-SIP report
[6] CGAP Pakistan I-SIP report
[7] Robert Cull, Asli Demirjuc-Kunt and Timothy Lyman, 20 May 2012, "Financial Inclusion and Stability: What Does Research Show?", http://www.cgap.org/publications/financial-inclusion-and-stability-what-does-research-show-0
[8] IAIS application paper on regulation and supervision supporting an inclusive insurance market.

Research on the linkages between FI and FS has concluded that:

- An inclusive financial sector will have a more diversified and stable retail deposit base, which should make the financial system more stable. Financial inclusion may also diversify credit portfolios and reduce concentrated lending, which in turn reduces systemic risk.
- Financial inclusion is a harbinger of economic stability. Job creation, poverty reduction and food security all contribute to financial stability.
- An inclusive financial system achieves balanced and sustainable economic growth by ensuring every individual enjoys a share of this growth. This in turn contributes to political, social and financial stability.
- A strong and resilient financial system promotes confidence in the system, which makes it more attractive to those who are financially excluded.
- Financial stability can have a positive impact on forces that reduce key prices, making financial services more affordable.

How do policymakers manage the twin responsibilities of FI and FS?

It is important that policymakers optimize the linkages between financial inclusion and financial stability. However, they must be careful to avoid policy interventions that achieve one at the expense of the other, or achieve neither in the short to medium term by failing to coordinate and share inter-agency responsibilities. The good news is that even though trade-offs are inevitable when pursuing these objectives, they can be managed with minimal impacts.

"Given the synergies between FI and FS, it is imperative that policymakers optimize the positive linkages between them."

Different countries have tried different approaches. While some have based their approach on past experience,[9] others have taken a conservative approach. Regardless of the approach, it is imperative that national policymakers follow the I-SIP guidance below, which has been altered slightly to reflect FI and FS objectives.

1. Clearly define FS and FI to provide clear guidance on national policy design and enable effective monitoring and measurement.
2. A structured approach to identifying material linkages between FI and FS objectives, which may arise when implementing a specific policy, helps to manage and optimize linkages and avoid false or unnecessary trade-offs.
3. Inter-and intra-agency collaboration is critical to designing, monitoring and adapting policy interventions that optimize linkages not only between FI and FS objectives, but between broader national objectives as well.
4. Using specific indicators and targets to regularly collect and analyze data on policy interventions enables policymakers to monitor the effects of the policy on FI and FS and to calibrate linkages over time.
5. Periodic, structured consultation with providers in proportion to the scale of the proposed changes helps to identify and manage linkages as the market develops.
6. Optimizing the linkages between FI and FS requires a commitment by policymakers to adapt policy and regulation as data and other evidence come to light and effects are observed.

[9] CGAP South Africa I-SIP report

The six I-SIP propositions above can serve as guidance for policymakers to create the right approach. One important consideration, however, is the ability of policymakers to synchronize the applicable propositions when developing and adopting a proportionate approach[10] customized to their country's needs.

Another important aspect will be ensuring that the global and national standards and policies being implemented to enhance the stability of the financial system (e.g. new Basel III regulations) do not unintentionally financially exclude individuals and small businesses, particularly in developing countries. Efforts such as AFI's to develop an "extended risk framework" that takes the risks of financial exclusion into account, which can arise from overly restrictive global standards or disproportionate implementation of standards by policymakers, will be important to ensuring financial inclusion and financial stability policies can be pursued in tandem.[11]

"The challenge lies in ensuring that global and national policy initiatives are coordinated and optimized with the active participation of government, the private sector and international bodies."

CONCLUSIONS

Globally, there is a growing understanding and consensus that financial inclusion and financial stability are mutually reinforcing and, if pursued in a coherent manner, can help policymakers build a resilient and inclusive financial sector and support social and economic growth. However, the challenge lies in ensuring global and national policy initiatives are coordinated and optimized with the active participation of government, the private sector and international bodies.

ACKNOWLEDGMENTS

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[10] The G20 Principles for Innovative Financial Inclusion define the "principle of proportionality" as "Balancing of risks and benefits against costs of regulation and supervision".
[11] AFI's Peer Learning Program with the global standard-setting bodies: http://www.afi-global.org/sites/default/files/pdfimages/afi_gpf2014_ssbs_fact_sheet_aw_low_res.pdf

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About AFI

The Alliance for Financial Inclusion (AFI) is a global network of financial inclusion policymaking bodies, including central banks, in developing countries. AFI provides its members with the tools and resources to share, develop and implement their knowledge of financial inclusion policies. We connect policymakers through online and face-to-face channels, supported by grants and links to strategic partners, so that policymakers can share their insights and implement the most appropriate financial inclusion policies for their country's individual circumstances.

Learn more: www.afi-global.org

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