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Dialogue

What Role Does Financial Inclusion Play in the Policy Agenda for Inclusive Growth in Sub-Saharan Africa?

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ABSTRACT *The economic growth and structural change currently taking place in sub-Saharan Africa relies on household enterprises to provide the main source of employment for the labour force. The financial sector will only contribute to inclusive growth if financial access can be extended to household enterprises. Promoting a more inclusive financial sector involves challenges for central banks in their role as regulators of the financial system.*

KEYWORDS *structural change; financial access; prudential regulation*

Introduction

The promotion of financial sector development has been prominent in the policy agenda of many developing countries since the widespread adoption of market-oriented economic policies in the 1980s and 1990s. The motivation for this policy development was cross-country empirical evidence that indicated a causal link between financial sector development (the deepening and broadening of the financial sector) and long-term economic growth (Levine, 1997). This agenda focussed mainly on formal sector financial institutions that serve a relatively narrow section of the economy and society, with the exception of efforts to promote microfinance. More recently, the financial development agenda has been broadened to incorporate the goal of 'financial inclusion', defined as widening access to financial services to poor people (Ardic *et al.*, 2011; Triki and Faye, 2013). Public institutions (mostly Central Banks) in 40 countries, including 16 in Sub-Saharan Africa (SSA), have signed the 2011 Maya Declaration of the Alliance for Financial Inclusion, committing themselves to taking measures that can improve access to, and lower the cost of, financial services (Alliance for Financial Inclusion, 2013). As shown in Table 1, in many countries of SSA, less than a third of households have access to a bank account, which is one, but not the only aspect of, financial exclusion.

Central banks, in implementing their key mandates of macroeconomic and financial stability, do not normally place much emphasis on issues of inequality or income distribution. This is not because they regard these issues as unimportant, but rather because the tools at their disposal – monetary policy and bank supervision – are ill suited to addressing such issues. Financial inclusion, with its explicit distributional focus,

therefore, involves somewhat unfamiliar objectives for central banks. The objective of this article is to explore the rationale for central banks in SSA according priority to financial inclusion.

The contention of the article is that the specific modalities of structural change in SSA, in which informal and household enterprises predominate, imply that access to financial services needs to be much more widespread among the population to support economic activities than would be the case if SSA were pursuing a development trajectory characterized by mass formal sector wage employment in modern industries, as is the case in the newly industrializing economies (NIEs) of East Asia. Nevertheless, financial inclusion is not a panacea for the household enterprise sector, which faces many other constraints besides access to financial services.

The article is organized as follows. The following section very briefly summarizes why financial development attained such a prominent place in the policy agenda in the 1980s and 1990s. The third section discusses the characteristics of structural transformation in SSA and compares these with other developing regions. Given these characteristics, the fourth section explores how financial inclusion could contribute to inclusive growth in SSA and the policy implications for central banks. Some concluding remarks follow.

Table 1. *Percentage of households with access to a bank account in selected SSA countries*

Country		Country	
Botswana	41	Nigeria	21
Kenya	27	Rwanda	26
Lesotho	18	South Africa	60
Malawi	19	Swaziland	35
Mozambique	12	Uganda	18
Namibia	45	Zambia	15

Source: Ardic *et al.* (2011), Table 1

Financial development and growth

The intuition behind the importance attached to the promotion of financial development in development strategies is straightforward. The financial sector links savers and investors. Without this link, most savings would be invested by savers themselves, in assets yielding low returns. Instead, an efficient financial sector allows savings to be pooled and invested in assets that can generate much higher rates of return, because of economies of scale and/or use of better technology. Moreover, if it is efficient and not subject to market imperfections, a competitive commercially oriented financial system itself will ensure that scarce resources – savings – are allocated to those assets that can generate the highest rates of return (McKinnon, 1973). Consequently, the marginal return to capital will be maximized, raising the economic growth rate. This role for the financial sector in development does not require any emphasis on financial inclusion *per se*, unless the financially excluded hold a substantial pool of untapped savings.

The theoretical arguments have been supported by a now large empirical literature that finds a causal relationship between the development of the financial system and long-run economic growth. In an extensive survey of the research, Levine (2005) concludes that countries with better functioning banks and financial markets grow faster and that better functioning financial systems ease the external financing constraints that impede the expansion of firms and industry. Furthermore, Clarke *et al.* (2006) and Beck *et al.* (2007) find that financial development boosts the income of the poorest sections of the population not only through its impact on aggregate economic growth but because it also reduces income inequality. However, a contrary view is put forward by Andersen *et al.* (2010), as they found no statistical significant relationship between measures of financial development and labour productivity growth in SSA during the period 1995–2005.

Financial sector reforms have figured prominently (and still do) in the reform programmes of many economies in SSA. These reforms have included the liberalization of financial markets, the restructuring and privatization of banks, the strengthening of the prudential regulation of banks, the promotion of securities and capital markets, and pension sector reforms. For the most part, and with the exception of efforts to promote

microfinance, financial sector reform programmes have focussed on the large-scale formal sectors, which serve a relatively narrow section of the population, that is, the corporate sector and higher income earners, and hence they have had virtually no impact on the extent of financial exclusion in SSA.

Growth and structural change in SSA

Most countries that have achieved sustained economic growth and development have done so through industrialization involving the large-scale shift of the labour force from low-productivity informal activities, mainly in agriculture, into wage employment in much higher productivity modern industries (Rodrik, 2013). Structural transformation of this nature underlies the success of the NIEs of East Asia. For example, in China between 1978 and 2007, the share of the labour force employed in agriculture fell from 69 percent to 26 percent, while the share employed in the non-state non-agricultural sector (which includes private sector manufacturing industry) rose from 27 percent to 70 percent. In 1978, average labour productivity in the non-agricultural sector was six times higher than in the agricultural sector (Zhu, 2012). The development trajectory pursued in East Asia entails private investment in labour intensive industry on a very large scale; it therefore requires both high rates of national savings and a financial system that can pool savings and allocate them to investors in manufacturing industry. It is the creation of mass employment in the modern sectors of the economy (where real wages are much higher than in agriculture, because labour productivity is much higher) that drives the rapid reduction in poverty achieved by the NIEs of East Asia. Whether the poor have access to financial services is, at most, of secondary importance for poverty reduction.

Although real economic growth rates have risen and poverty rates have fallen in SSA since the 1990s, structural transformation of the type that characterizes developing Asia is not occurring in SSA. There has been very little growth in manufacturing industry, the share of which in GDP and employment has stagnated or fallen since the 1990s (Ajakaiye and Page, 2012). Instead, economic growth has been led by the expansion of the services sector, especially retail and wholesale trade, a large part of which comprises informal activities in which labour productivity is higher than in agriculture but productivity growth is very weak (Vries *et al.*, 2013). Jedwab (2013) argues that the predominance of natural resource exports in SSA has led to a shift in employment into what he dubs 'consumption cities' in which economic activity is dominated by non-tradeable services, rather than manufacturing.

Table 2. *Type of employment in SSA (percentage shares of the workforce)*

	2005	2010
Agriculture	65.2	59.3
Household enterprise	17.1	21.4
Wage industry	2.7	2.8
Wage services	11.2	12.6
Total employment	96.2	96.1
Unemployed	3.8	3.9
Labour force	100	100

Source: Fox *et al.* (2013), Appendix Table 2

The absence of structural change involving a large-scale shift of labour out of agriculture and into formal sector wage employment is demonstrated clearly in the employment data collated by Fox *et al.* (2013) and summarized in Table 2. Only a small fraction of the labour force in SSA, an average of 15 percent in 2010, works in wage employment in either industry or services (including informal businesses), a share which is growing at only a very slow pace. In contrast, more than 80 percent of the labour force works in agriculture, mainly as smallholder farmers, or in non-farm household enterprises, which include the self-employed. The shifts in the structure of employment that have accompanied the acceleration of economic growth in SSA since the 1990s have mainly entailed labour moving from agriculture into non-farm household enterprises. Furthermore, even if the recent strong growth momentum in SSA can be sustained into the future, the structure of employment is unlikely to change very much in the next decade. Because the demographic transition has been delayed in

SSA, the labour force is expanding at around 3 percent per year. The rapid growth in the labour force, together with the fact that the share of wage employment in the labour force is currently so small, means that increasing this share requires very high growth rates of wage employment, and therefore very high levels of capital investment in modern industries (Fox *et al.*, 2013). Private investment rates in SSA are relatively modest and much lower than in developing Asia. Furthermore, many of the people engaged in household enterprises lack the minimum education that is often required for wage employment in the formal economy.

Even though the vast majority of the labour force in SSA still depends on non-wage income for their livelihoods, Fox and Pimhidzai (2011), utilizing data from Uganda, argue that there are transformations taking place in the way in which people earn their living that are welfare enhancing and contribute to poverty reduction. These transformations all involve household enterprises. There has been a shift of labour from agriculture to non-farm household enterprises, a diversification of income-generating activities by farmers to include non-farm household enterprises as secondary occupations and increased commercialization and diversification of agricultural activity by farmers. Given the obstacles to a rapid shift in the structure of the labour force towards wage employment in the formal sector discussed above, for the foreseeable future, inclusive economic growth and poverty reduction in SSA will continue to rely on the expansion of household enterprises in farm and non-farm sectors of the economy and the raising of productivity within these enterprises, especially in smallholder agriculture.

How can the financial sector contribute to inclusive growth?

A financial sector that excludes 70 percent of the population, as is typically the case in SSA, will only make a limited contribution to inclusive growth, if that growth depends on household enterprises to provide incomes for the majority of the workforce. Whether or not household enterprises can provide opportunities for raising the incomes of those who work in them depends in part on households being able to acquire productive assets and working capital inputs. A more inclusive financial system could support household enterprises by offering them access to credit for working capital or small purchases of equipment. Facilities for the frequent deposit of business revenues would also be valuable for household enterprises, allowing them to accumulate financial assets that might also be used to purchase capital goods or to facilitate future access to loans. Insurance might also be useful for many household enterprises. Karlan *et al.* (2014) analyze evidence from northern Ghana and find that investment decisions of smallholder farmers are constrained by risk. The provision of insurance against poor rainfall encourages smallholders to increase their investments and bear larger risks. However, to maximize the benefits of access to financial services, it may be necessary to improve the financial literacy of potential customers.

As noted above, microfinance has been part of the policy agenda in SSA since around the end of the 1990s.[1] Microfinance involves utilizing a specialized type of financial institution – the Microfinance Institution (MFI) – to serve poor people with micro-loans and in some cases micro-savings products. The financial inclusion agenda is much broader and it is not confined to specialized institutions such as MFIs; rather it aims to encourage a wide range of financial institution, including commercial banks, to extend to the poor access to their services.

Is there empirical evidence that enhanced financial inclusion can support the growth of household enterprises in SSA? Most of the empirical studies have examined microfinance and micro-savings rather than the broader agenda of financial inclusion. A systematic review of existing empirical studies in SSA by Rooyen *et al.* (2012) concluded that microcredit has modest though not uniform benefits to those who have access to it, but that in some cases the impact is negative (poverty is increased), while access to micro-savings has no discernible impact on incomes. Cull *et al.* (2014) also review empirical studies in developing countries on the impact of access to a range of financial products, including research using randomized control trials. The evidence of the impact on household welfare is somewhat mixed and there is

considerable heterogeneity in impacts across households, although several studies found a positive impact of microcredit on new business creation and the growth of businesses. The smaller number of studies of micro-saving schemes generally found positive benefits in terms of helping households to accumulate savings and smooth their consumption.

There are two possible ways, which are not mutually exclusive, in which these mixed results of the impact of access to financial services on poor households can be interpreted. The first is that the needs and abilities of poor households to access and make use of financial services are very heterogeneous, and therefore the benefits of increased access to financial services depend on the specific characteristics of these services and how well suited they are to the specific requirements of households (i.e., some financial products have been useful, while others have not). The second is that access to financial services by household enterprises is complementary to other interventions that alleviate the constraints faced by these enterprises. Hence, it is only in combination with complementary interventions that improved access to financial services will yield positive benefits. For example, smallholder farmers in SSA face a raft of constraints to raising productivity and output, including lack of knowledge of, and access to, improved technologies and the difficulties and cost of accessing markets (Drew, 2010). In such circumstances, a precondition for smallholders to benefit from increased access to financial services is enhanced provision of good quality agriculture extension services, to encourage them to adopt good agricultural practises, and improved rural infrastructure to reduce the cost of accessing markets.

The main factors that underlie the exclusion of the poor from financial services are financial. For many financial institutions, serving the poor on a large scale is not commercially viable. Once financial institutions move out of urban areas, the costs of providing financial services are high, whereas the revenues per customer that can be earned are very low. Furthermore, demand for financial services by the poor is impeded by the costs of accessing these services, which includes both the transactions costs of operating accounts and the costs of physical access to financial institutions in rural areas. Financial inclusion will only be reduced if the cost benefit calculus can be shifted. Technology offers prospects for dramatically reducing costs by delivering financial services in innovative ways, especially through mobile banking, which has become one of the most important channels for promoting financial access in SSA (Porteus, 2012; Faye and Triki, 2013).

What are the implications for public policy of an objective to promote financial inclusion? For central banks, one of whose core mandates is financial regulation, a key issue is how this objective affects regulatory policy.[2] The initiative for developing and introducing technological innovations such as mobile banking has emanated mainly from the private sector, with public policy playing a largely passive role. Central banks face a potential dilemma in that they do not want to stifle innovations that have the potential to expand financial access, but they nevertheless need to provide safeguards against fraud or mismanagement that might lead to numerous poor people losing their savings. One way to resolve this dilemma is to adopt a liberal attitude towards innovations, provided that any funds mobilized from the public are held with financial institutions that are licensed to take deposits. This would mean that institutions offering mobile money services that are not licensed to take deposits cannot intermediate the funds they mobilize. For example, in Uganda, each of the six mobile money providers, none of which are themselves licensed financial institutions, must hold the equivalent of all of the virtual money sold to their customers in an escrow account with a partner commercial bank.

At present, given the bulk of mobile money services offered to customers being payment services, the prudential risks are still relatively small. However, with a new generation of mobile banking models likely to emerge in the near future, involving diverse new entrants offering niche products through mobile phone-based internet, prudential risks to poor customers may become more pervasive (Porteous, 2012). As the scope of mobile banking is widened, the principle that financial intermediation of customers funds should only be undertaken by licensed financial institutions should be maintained

by central banks. Central banks will also be concerned about operational risk in the mobile banking providers, because of the potentially disruptive impact on the payments system if this risk were to materialize. There are also public policy issues pertaining to competition (e.g., the access of competitors to the infrastructure platforms of mobile phone operators) and consumer protection. Consumer protection is probably best safeguarded through requirements for proper disclosure of the terms and conditions of access to financial services, for example, the fees charged.

Conclusions

Household enterprises provide more than 80 percent of employment opportunities in SSA, a share that is unlikely to fall considerably over the next decade. Consequently, inclusive growth will only be possible if the household enterprise sector, which includes smallholder farming as well as non-farm enterprises, can both expand and increase its productivity. A financial sector that does not serve household enterprises will not contribute to inclusive growth. Hence extending financial access can be warranted as a tool for supporting inclusive growth in SSA, although it is not, *per se*, a panacea; many other complementary policies, such as agricultural extension services for smallholder farmers are equally, if not more crucial, for alleviating the constraints to growth.

The promotion of financial inclusion is not straightforward for public policy. Most of the successful innovations, such as mobile banking, are the result of private sector initiatives. Public policy needs to provide room for new innovations in the financial sector and to focus regulation only on those components of financial services that entail genuine prudential risk to customers or where there are very clear abuses of market power to restrict competition.

Notes

1 Bateman and Chang (2012) offer a critique of this agenda, arguing that it risks entrenching a suboptimal allocation of scarce resources in enterprises that are too small to realize the economies of scale needed to propel development.

2 Klein and Mayer (2011) provide a framework for analyzing the design of regulation of mobile banking, based on the nature of the products offered to customers.

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