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Financial Inclusion and Financial Stability

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ABSTRACT

Recently the importance of financial inclusion based on the principle of equity and on inclusive growth with stability has engaged the renewed attention of policy makers internationally. It is being increasingly recognized that despite tremendous growth in the banking sector and significant improvements in all areas relating to financial viability, profitability and competitiveness, the glass remains half-full. There remain concerns that banks have not been able to include vast segments of the population, especially the underprivileged sections of the society, into the fold of basic banking and financial services. This article focuses on different aspects of financial inclusion and financial stability in present economic scenario.

Introduction:

The importance of financial inclusion based on the principle of equity and on inclusive growth with stability has engaged the renewed attention of policy makers internationally in recent years. It is being increasingly recognized that despite tremendous growth in the banking sector and significant improvements in all areas relating to financial viability, profitability and competitiveness, the glass remains half-full. There remain concerns that banks have not been able to include vast segments of the population, especially the underprivileged sections of the society, into the fold of basic banking and financial services.

The recent global financial crisis has also brought the focus on financial stability to the centre stage. The debate has been quite wide-ranging encompassing, inter alia, the definition of financial stability and the implication of financial stability for growth and welfare. Many lessons have been learnt. One, that financial stability can be jeopardized even if there is price and macroeconomic stability. Two, that financial stability has to shift from being an implicit variable to an explicit variable of economic policy and three, that a threat to financial stability anywhere in the world is potentially a threat to financial stability everywhere. Fourth and most importantly, we have learnt that while financial instability can hurt even the most advanced economies, the damage it can cause in poor and developing economies can be particularly severe. People with low levels of income have no headroom to bear downside risks, and their livelihoods can be disrupted by financial instability. It is therefore even more important that countries such as ours pay particular attention to preserving financial stability even as we deepen and broaden our financial sector at home and integrate with the rest of the world.

The developments in the recent years have ensured that the pursuit of financial inclusion and the pursuit of financial stability are no longer policy options but policy compulsions. The key challenges emerging from this conclusion is how to achieve the goal of financial inclusion, i.e., providing basic financial facilities to a wider segment of society while ensuring that the stability of the financial system is not compromised. An important question which emerges is whether increased and wider access to the formal financial services works in tandem with policies aimed at enhancing financial stability or does it work at cross purposes and jeopardize financial stability, i.e., are financial inclusion and financial stability two sides of the same coin or are they two different disparate goals.

The relationship between financial stability and financial inclusion is that the two must co-exist. Financial inclusion may be difficult without the stability of the financial system while it is difficult to envisage continuing financial stability when an increasing chunk of the socio-economic system remains financially excluded. Financial inclusion has been defined, by the Committee on Financial Inclusion, as the process of ensuring access to financial services and timely and adequate credit where needed by vulnerable groups such as weaker sections and low income groups at an affordable cost . It primarily represents access to a bank account backed by deposit insurance, access to affordable credit and the payments system.

There has been significant, albeit, slow progress towards greater financial inclusion around the world in recent years. According to estimates by an ADB Working Paper, in Africa, Kenya has pioneered an interesting process of financial inclusion through mobile phone payment solutions. Latin American countries such as Peru and Bolivia have attempted to put in place some very enabling regulatory environments for microfinance. In these two countries, rapid growth over the past seven years has included six million clients in the formal financial system. Brazilian policymakers achieved universal coverage of over 5,500 municipalities by enabling banks to use retail agents. This new low-cost delivery channel triggered expansion of formal financial services to 12 million clients in only six years. Latin America has also demonstrated the potential of conditional cash transfers into simplified bank accounts as a way to connect beneficiaries to formal finance while simultaneously lowering delivery costs to the government. Transfer challenges motivated the use of agents in Brazil. In Mexico, beneficiaries increased savings and investment with more than 90 per cent of households started to use banking services.

The benefits from financial inclusion are well understood and well documented. Financial inclusion, more particularly when promoted in the wider context of economic inclusion, can uplift financial conditions and improve the standards of lives of the poor and the disadvantaged. Access to affordable financial services would lead to increasing economic activities and employment opportunities for rural households with a possible multiplier effect on the economy. It could enable a higher disposable income in the hands of rural households leading to greater savings and a wider deposit base for banks and other financial institutions. It will enable the Government to provide social development benefits and subsidies directly to the beneficiary bank accounts, thereby drastically reducing leakages and pilferages in social welfare schemes. Thus, financial inclusion could be an instrument to provide monetary fuel for economic growth and is critical for achieving inclusive growth. Further, expanding the reach of financial services to those individuals who do not currently have access would be an objective that is fully consistent with the people-centric definition of inclusive growth which attempts to bridge the various divides in an economy and society, between the rich and the poor, between the rural and urban populace, and between one region and another.

Financial inclusion is the key to inclusive growth with its motto of empowerment of poor, underprivileged and low income/skilled rural/urban households. Poverty is not merely insufficient income rather the absence of wide range of capabilities, including security and ability to participate in economic and political systems. Financial inclusion is designed to bring about the capability to participate and contribute among the economically and socially excluded people by creating equal opportunities. Achieving sustainable financial inclusion will require a systemic effort which leverages technology, viable business models and appropriate regulatory framework cohesively. While further research is needed to better understand the transmission channels and potential feedback loops between financial stability and financial access and to identify policy solutions aiming to balance both objectives in a sustainable manner, it is evident that financial inclusion and financial stability need to coexist. The Indian experience has proved that financial inclusion can work within the framework of financial stability given an enabling regulatory environment. The twin objectives of financial stability and financial inclusion are arguably two sides of a coin but it is imperative that a robust risk-mitigating framework which exploits their complementarities while minimizing the conflicts is adopted to ensure that they do not work at cross purposes.