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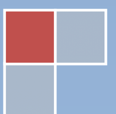
FINANCIAL SECTOR DEVELOPMENT STRATEGY FOR INCLUSIVE GROWTH

NEPAL RASTRA BANK



Financial Sector Development Strategy for Inclusive Growth

BACKGROUND PAPER[1]

ABSTRACT

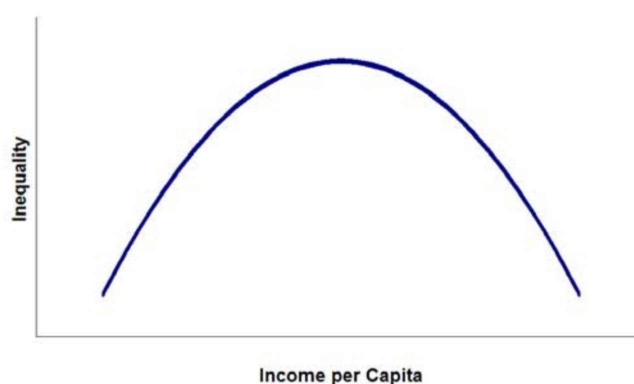
The focus of economic planning has shifted from simply economic growth to the need for also reducing inequality through people's wider participation in economic activities. This changing emphasis is reflected in the discussions for broad-based and inclusive growth. However, a conceptual gap remains with regard to the role of the financial sector in contributing to this growth. This paper attempts to fill this gap and highlights some characteristics of the financial sector that contribute to productive employment and promote inclusive growth. The characteristics can be reflected in (i) financial access, (ii) credit policy and (iii) financial safety net, among others. All these characteristics require a more active role of financial sector regulators and suggest a system that is stronger than simply inclusive finance. Hence, it can be labelled as inclusive finance plus. For achieving this, while restructuring of the financial sector in necessary, guidance to the financial sector is required for shaping its pathway. A credible financial sector development strategy is essential to ensure wider access to financial services, prudent allocation of financial resources, and effective provision of financial safety nets for achieving and sustaining inclusive growth.

[1] *Prepared by Nepal Rastra Bank for presentation at the* ***49th SEACEN Governors' Conference/High-level Seminar****, 21–23 November 2013, Kathmandu, Nepal. The contribution of Dr. Min B. Shrestha, Dr. Binod Atreya, Dr. Nephil Matangi Maskay and Dr. Bhubanesh Pant in drafting this background paper is acknowledged.*

1. Background

Economic growth does not necessarily reduce poverty; nor does it raise employment. Often rapid growth widens inequality. This, in turn, makes growth unsustainable. This understanding has taken time to be established. The concept of economic planning till later twentieth century was based on the assumption that there was a trade-off between income growth and inequality. This concept is exemplified in Kuznet's (1955) hypothesis, which explicitly shows a trade-off between income per capita and inequality, where moving rightward along the Kuznets curve involves a combination of an increase in income per capita with a deterioration of income distribution. However, after a certain point in the trajectory of income per capita, a "turning point" occurs where inequality eventually starts to decline (Figure 1). The consensus at that time was that the benefits from economic growth (that is, graduating up the levels of income per capita) would eventually "trickle down" to lower echelon of society and thus the deterioration in inequality would be naturally self-correcting. Hence, economic planning during the later part of 20th century focused on enhancing economic efficiency through liberalization, deregulation and privatization. This also implied a diminishing role of the state in the economy.

Figure 1: Hypothetical Kuznets Curve



Source: Kuznets (1955)

The prescription of international financial institutions in the early period was thus a sole focus on enhancing the efficiency, such as of the financial sector, through liberalization and deregulation. This also resulted in reducing the role of the state in the financial sector as in other economic activities. Many countries followed similar prescriptions under the aegis of international financial institutions. Nepal, a low income developing country, also followed this track starting from the late 1980s—examples in this regard include the liberalization of trade, industry, and financial institutions licensing policy, deregulation of interest rates, full convertibility of current account, liberalization of capital account and deregulation of administered prices, among others.

However, the experiences of many countries with policies for accelerating economic growth through economic liberalization and privatization find that while those activities have indeed spurted economic growth and reduced aggregate poverty levels, they have instead resulted in widening of income inequality (UN, 2010). Further, the lack of validation of the Kuznets curve was worrying to most policy makers where empirical evidence "defied the notion that the fruits of growth eventually trickled down to the poorer segments of developing societies, causing the emergence of concern about the distributional effects of growth" (Ranieri and Ramos, 2013). There was thus a shift in development thinking, which focused on the economic growth process with acknowledgement that there is a role for the state for promoting inclusive growth and reducing inequality.[2]

In the above context, perception slowly changed from that of a trade-off to an understanding that economic growth and equality can, and should, go hand in hand. This understanding opened up an era of economic thinking and planning in which a host of factors increasingly oriented the debate toward how to promote economic growth with equality without having to reach the threshold for inequality to naturally self correct. This initiated discussion of pro-poor growth—growth that actually benefits the poor and led to more state income distribution schemes. While the concept of pro-poor growth is clear and logical, there is no clear consensus on its definition—that is, there is the "weak but absolute definition of pro-poor growth" which refers to increased income for the poor, while the "relative definition of pro-poor growth"

[2] This was apparent in World Bank's 1974 publication entitled *Redistribution with Growth* and subsequent policies, such as India's 3rd Five Year Plan (as quoted in Ranieri and Ramos, 2013, p. 2).

refers to growth that leads to disproportionate increases in incomes among the poor (which is accompanied by declining inequality). Further it was felt that transfer schemes were not the answer in the long run and could be problematic even in the short run by imposing significant burden on state budgets.

Amidst this unfolding discussion over pro-poor growth, the concept of inclusive growth emerged. It differs from the concept of pro-poor growth since it places emphasis on participation of all people regardless of their income category for benefitting from the growth process. As with discussion on pro-poor growth, there is also no consensus definition for inclusive growth; however, inclusive growth focuses on productive employment and refers both to the pace and pattern of growth, which is taken as being interlinked and therefore must be addressed together. Thus, growth can be taken as inclusive when it creates economic opportunities at large along with ensuring equal access to them.

This background paper focuses on how the financial sector can contribute and promote inclusive growth. While there has been significant discussion on inclusive growth, a gap exists in this regard.This paper attempts to fill the gap and intends to:

- discuss the role of financial sector in achieving inclusive growth;
- examine some issues for reengineering the financial sector that supports inclusive growth, including the need for a credible financial sector development strategy; and
- provide insights into some activities undertaken with regard to financial inclusion, with examples from Nepal.

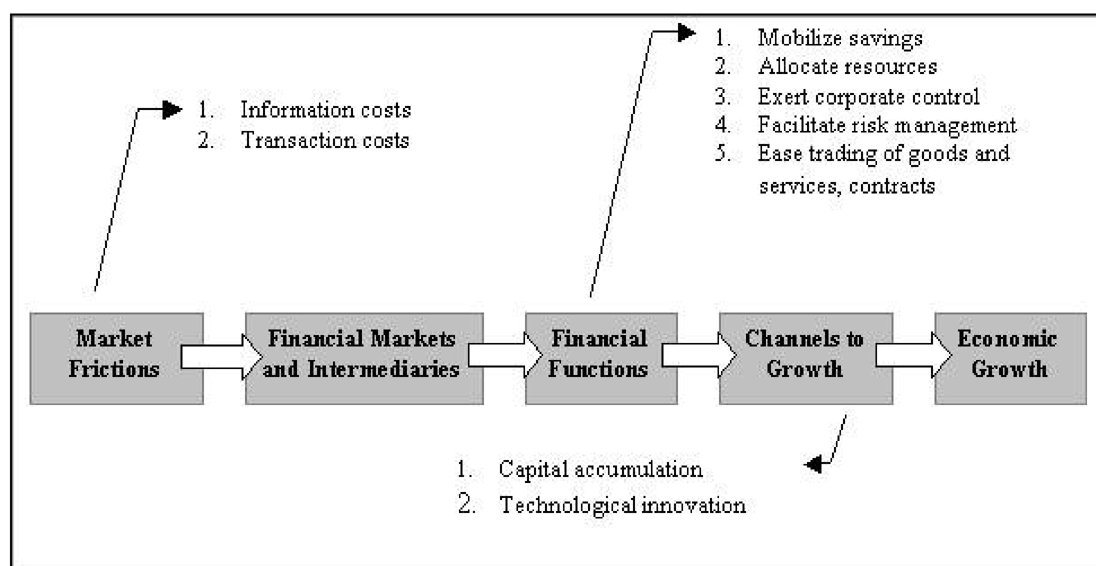
The paper ends by highlighting some issues such as the need for a financial sector development strategy to guide the financial sector for supporting inclusive growth, especially in emerging economies.

2. Role of Financial Sector for Achieving Inclusive Growth

Financial sector is taken as the set of institutions, instruments, and the regulatory framework that permit transactions to be made by incurring and settling debts, that is, by extending credit. The conventional perspective is that the financial sector plays an important role in economic development since it facilitates the allocation of credit and fuels economic growth. This is based on the IS-LM framework which implicitly assumes that the financial sector is able to efficiently allocate scarce funds and risk. In this regard, financial sector development can enhance competition among financial intermediaries and therefore enhance the quality of financial services that are provided to the rest of the economy. An efficient financial sector lowers the cost and risk of producing and trading goods and services and thereby provides the essentials for income-growth and employment creation, thus making a vital contribution to raising standards of living (Sen, 2010).

The conceptual channels by which financial sector development leads to economic growth are illustrated in Figure 2 below. It depicts how financial intermediaries are related to economic growth by means of overcoming market frictions (such as information costs and transaction costs) and affecting saving and resource allocation decisions. Some economists find two channels through which each financial function may impact growth: capital accumulation and technological innovation (Levine, 1997). The financial sector affects resource allocation either by altering the savings rate or by reallocating the savings among different capital producing technologies. In terms of technological innovation, the functions carried out by the financial sector affect economic growth by altering the rate of technological innovation.

Figure 2: The Financial Sector-Economic Growth Nexus



Source: Ozer (2008)

Some cross-country level works (King and Levine, 1993 and Levine and Zervos, 1998) suggest that measures of financial sector development (such as credit to GDP ratio) are vigorously related to economic growth. Even the endogenous growth literature, building on 'learning by doing' processes, allocates a special role to finance (Aghion and Howitt, 1998). Further, cross-country findings also show that financial sector promotes growth through increase in productivity (Ayyagari, Demirgüç-Kuntand and Maksimovic, 2007). Moreover, it has also been revealed that financial sector development plays an instrumental role in moderating the impact of external shocks on the domestic economy (Beck, Lundberg and Majnoni, 2006). Some studies (Balakrishnan et. al, 2013) find that financial sector development not only promotes but facilitates the even distribution of economic growth.

However, it has also been exhibited that while financial sector development can result in higher economic growth, it is unclear whether or not it will lead to greater poverty reduction (Holden and Propenko, 2001). Two factors are responsible for this. One, the impact of financial sector development on poverty reduction is itself governed by the level of income or asset inequality in the country. For countries with high levels of inequality, the impact of growth on poverty, and thus of finance on poverty, will be less than that for countries with low levels of inequality. Two, financial sector development may itself aggravate inequality in the country. Thus, as banks and other financial intermediaries increase in size and number, they may opt to lend only to those who possess collateral and who can borrow against such collateral. Poorer

households or small and micro enterprises which do not have access to collateral may be rationed out of financial markets. Thus, the conventional measure of financial sector development does not really capture the distribution of credit, but only focuses on an aggregate perspective.

Prior to addressing the distribution concern of credit, it should be first clear that the foundation of economic growth is critical for having inclusive growth. In this regard, financial sector development and its stability is a precondition for any kind of growth; and it implies the ability of the financial sector to smoothly carry out its key economic functions at all times, including in stress situations and periods of structural upheaval. In particular, it refers to financial sector deepening and an efficient allocation of financial resources and risks along with the provision of a well functioning financial infrastructure, such as payment and settlement system. Financial stability as such is a precondition for the real economy to generate jobs, promote economic activities and sustain economic growth. The primary role of the central bank and other regulatory authorities thus appears to ensure macroeconomic and financial stability. In this respect, the monetary authority must accord priority on its primary role for macroeconomic and financial system stability (Khatiwada, 2013).

Beyond this macroeconomic perspective and for contributing to making growth inclusive, three characteristics for the financial sector (i.e. the microeconomic perspective) are highlighted:

- **The first characteristic is access to finance,** which is an essential ingredient of the economic development process. Modern development theories stress the key role of access to credit for economic growth, of any kind it may be. In many developing countries, small-scale enterprises and micro-entrepreneurs face severe financing constraints; and financial services, particularly micro and SME finance provided by financial sector, ensure wider economic participation, create jobs and self employment, and realize their full potential. Likewise, access of the poor and vulnerable groups to finance is a pre-requisite for inclusive growth, poverty reduction and well being. Further, it empowers the vulnerable groups by giving them an opportunity to participate in economic activities, to have a bank account to save and partake in credit, and to access other financial services thereby facilitating them to break the chain of poverty.

- **The second characteristic is a mechanism that supplies credit to basic production sectors without compromising on the quality of financial services.** In this regard it is essential that there be sufficient allocation of credit to the sectors which engage large section of labour force. If necessary, state subsidies on interest, insurance premium, on credit plus services, etc. could be part of this targeted program. Such an allocation promotes formalization of informal sector, links finance to real output, and creates more jobs.
- **The third characteristic is a financial safety net:** The financial sector has an instrumental role to play in providing financial and social protection (a "safety net") to the society at large. Financial sector can play a vital role in ensuring basic liquidity and credit flows even at a time of financial crisis along with enhancing and protecting the income of the poor, in providing insurance (at the micro level) and in facilitating safe, prompt and affordable money transfers and payments.

The financial sector does not automatically take above mentioned characteristics which facilitate inclusive growth. This implies that the role of the state and the regulators has to be reassessed with the new paradigm of economic planning targetting economic growth with equality. The notion of a tradeoff between economic growth and inequality has also been challenged by the East Asian experience of high growth and low levels of inequality and suggests that there is a role for "state strategic activism in coordination with key private-sector elements" (Ranieri and Ramos, 2013). Development does not happen naturally and instead requires enacting the appropriate policies (Stiglitz and Squire, 1998). For attaining inclusive growth and development, leadership is important along with resource. Therefore, the G8 countries have agreed to "cultivate a broad-based government commitment to financial inclusion to alleviate poverty" as the first principle for innovative financial inclusion. In this regard, the proactive approach of state actors, namely financial sector regulators, is needed in addressing the policy and regulatory framework which also link both macroeconomic and microeconomic perspective as well as ensuring coordination with all the stakeholders that are vital for inclusive growth.

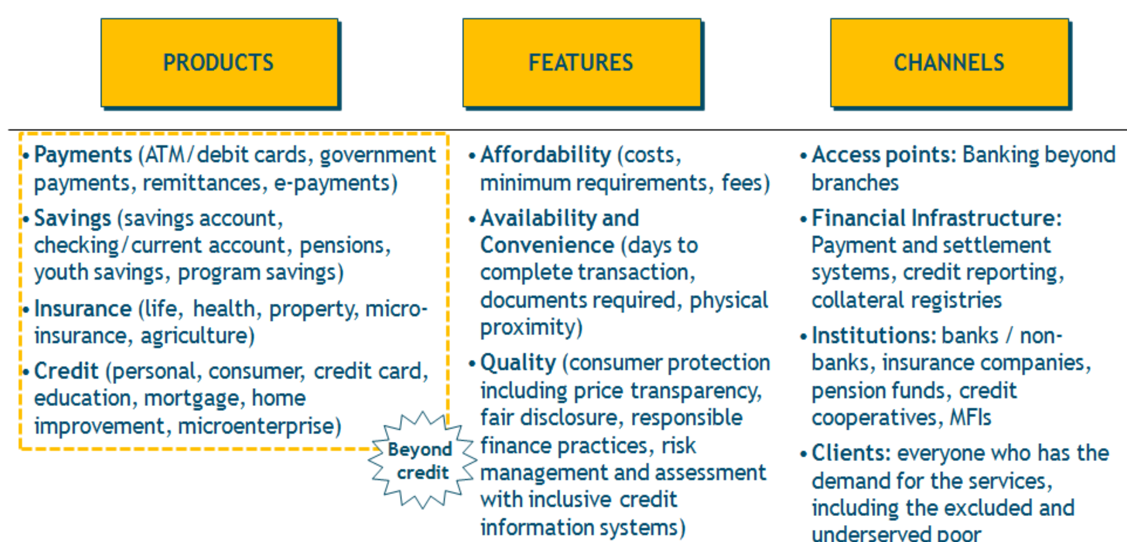
There also exists a bi-directional feedback loop from inclusive growth to the financial sector. An inclusive growth makes more people bankable and thus widens the demand for financial services at large. The feedback from inclusive growth (which leads to productive employment) to financial sector is via access to the productive resources and quality of financial services that widens and deepen the financial sector and thus ensure financial stability.

2.1 Stronger Inclusive Financial Sector

Preceeding discussion suggests that the characteristics of financial system that supports inclusive growth is typically an inclusive financial system. This sub-section elaborates on those characteristics and discusses this type of financial sector.

Defining Inclusive Finance: Inclusive finance is defined as a "state in which all people of working age have access to a full suite of quality financial services, provided at affordable prices, in a convenient manner, and with dignity for the clients" (Stein, 2010). It encompasses normally the access of financial services, at reasonable cost, especially to low income groups (Kanther and Nagabhushan, 2012). It focuses on (a) access at a reasonable cost of all households and enterprises to the range of financial services for which they are "bankable", (b) sound institutions, guided by appropriate internal management systems, (c) financial and institutional sustainability as a means of providing access to financial services over time, and (d) multiple providers of financial services, so as to bring cost-effectiveness and a wide variety of alternatives to customers (UN, 2006). The key dimensions of inclusive finance are summarized in Figure 3.

Figure 3: Key Dimensions of Inclusive Finance



Source: Stein (2010)

Figure 3 suggests that "access" of financial services to the rural households is the heart of inclusive finance. It is viewed that safe savings, appropriately designed loans for poor and low-income households and for micro, small and medium-sized enterprises,

and appropriate insurance and payments services can help people to increase incomes, acquire capital, manage risk, and work their way out of poverty.

The significance of inclusive finance stems from the fact that more than 75 percent of the world's poor are excluded from formal financial services (Demirgüç-Kunt and Klapper, 2012). About 60 percent of the population in East Asia and 80 percent of that in South Asia do not have access to the formal financial system. These data suggest a great challenge and the need for inclusive finance to serve the rural populace. However, deepening itself may not translate into financial services being broadly available across firms and households, making "access to finance" equally important (Balakrishnan et al., 2013).

There are diverse service providers including commercial banks, development banks, micro finance institutions, licensed non-bank financial intermediaries, cooperatives societies, postal saving banks, Financial Non Governmental Organizations (FINGOs), and informal organizations (such as self-help trusts and money lenders) involved in delivering financial services in this market. The promoters of these institutions range from the government to the non government and community organizations. Donors' roles are also equally important in promoting such services in low income countries. These organizations are guided by their respective policies, rules and modules of operations and often influence the institutional financial, and operational models of the financial organizations.

Constraints to Inclusive Finance: There are constraints at both the demand and supply sides of inclusive finance which have limited the access of financial services to the rural poor. It is suggested that (a) geography or physical access, (b) lack of proper documentation, and (c) high prices, minimum account requirements and fees work as constraints for inclusive finance (Demirgüç-Kunt, 2010). United Nations (2006) has also highlighted that (a) cultural factors, (b) mistrust of financial institutions, (c) transactions costs, (d) financial literacy and skill capacity, and (e) access to basic infrastructure are the barriers to inclusive finance from the demand side. The supply side factors comprised of the following: (a) financial viability of microfinance institutions, (b) real and perceived risk in micro lending, (c) institutions and linkages with the formal sector, and (d) approaches and products.

Personal and cultural characteristics (such as caste systems, exclusion of ethnic minorities, religious beliefs, gender, age, and requirements of various legal documents) have discouraged the rural poor from accessing the financial services. Gender biasness is often noted prohibiting credit facilities to women (Demirgüç-Kunt

et. al, 2013). Service providers, including insurance organizations, that normally target middle-aged economically active population and restrictive clauses make it difficult to avail financial services for older and younger population. The required documentation (identification card, citizen certificate, birth certificate and legal paper for asset holding) and the cumbersome policies often discourage rural households from banking and other financial services.

Collateral based lending practices of the financial intermediaries and lack of bankable collateral among the poor, and particularly among women - who own very small fraction of family property in their name - result in systematic exclusion of such people from bank credit. Even in micro finance services which focus on collateral free lending under group guarantee, there are exclusionary trends in group formation itself. In a society where social classes exist, the ultra poor and some section of the society are left out in the very group formation process. So even the collateral free lending practice becomes exclusionary if due care is not given to encompass the ultra poor or 'outcasted' people through better social mobilization.

Mistrust on financial institutions restrains the demand for financial services. Generally, customers want safety and security of their funds as well as convenience, liquidity, confidentiality, good service, credit facilities, and good returns from service providers. If these factors are limited and cases of corruptions and misuse of funds are reported, this would likely have a negative effect on the trust and creditability of the service providers, thereby restraining the demand of financial services.

Transaction costs is an issue of discussion in inclusive finance. Higher interest rates have always been an issue for micro finance. Compared to the commercial banks, MFIs' interest rates are higher due to high operating costs for small transactions. Similarly, literacy and capability programs help the rural households to make informed decisions. But, in its absence, rural households are unable to know how bank operates, their rights and obligations, contractual and legal consequences and skills and knowledge for operating businesses; and these restraint the poor people to make informed decisions. The significance of basic infrastructure stems from the fact that it improves the capability of rural households in accessing education, health services, business opportunities and reducing risks of operations.

Understanding the poor people’s financial needs, behavior, and preferences and translating them to a better service offering need to be considered for increasing the demand of financial services. The need, therefore, is to move away from a conventional approach (selling products to client) to a client-centric approach.

Looking at the supply side, financial viability of the institutions involved is an issue raised on the ground that the objective of 'double bottom line'; that is, seeking profit versus pursuing economic and social development, is a concern for service providers. The other issues such as high costs involved in small transactions, economies of scale, lack of capital, weak human resources and capability, wider competition with the larger banks and dependency on donors' funds, among others, add complexity for financial viability. Lending to small borrowers is still conceived as a risky business. Despite the research evidences (Christen, 1997 and Chowdri, 2004) that credit to poor households is comparatively less risky, lending to rural households is perceived as a risky business because of geographical distance, difficulties in monitoring and supervision, problems in generating data and information and also due to inherent weaknesses of the service providers. Lack of financial intermediation with mainstream financial market restrains MFIs to increase their credit portfolios due to constraints in borrowing funds, mobilizing savings, and accessing debt and short-term funds. The need for innovation in products and delivery mechanisms in line with customer needs, want and affordability is another challenge for service providers.

Beyond Inclusive Finance: The above discussion largely covers characteristic of access to finance. Financial inclusion is a multifaceted agenda with very wide-ranging categories, including microfinance, micro-insurance, micro savings, payment systems, agent banking, and the like. Stakeholders include the state, state actors, nongovernmental organizations, interested members of the international community, regulators, financial and non-financial service providers, consumers, and the public. Thus two further characteristics are necessary in this regard, namely:

- **Credit Policy:** Credit policy ensures supply of credit for driving economic growth. However the distribution of credit should not be left to the financial sector since it naturally provides credit to the most profitable venture. Often times, the financial market also tends to misallocate funds, like in the real estate or property market. In this regard, it is essential that there be credible sectoral allocation of credit to the identified productive sectors. Additionally, one important area is targeted credit, which, if allowed to run on basic market principle and on transparent fiscal or budgetary support will better ensure financial inclusiveness. The failure of previous models of directed credit should help us to refine the approach and make it successful for sustainable inclusive financial development.

- **Financial Safety Nets:** Promoting inclusive growth requires the government to formulate national strategies on social safety nets to mitigate the effects of shocks and vulnerabilities associated with their livelihoods. Social safety nets are also needed at least to meet the minimum needs of the chronically poor people, who may not be able to benefit from the opportunities created by growth strategies due to circumstances beyond their control. Livelihood shocks may emanate from ill health, economic crisis, natural disaster and unemployment, among others. Generally, policies on social safety nets could include (a) labor market policies and programs aimed at reducing the risks of unemployment, (b) social insurance programs to cover the risks of ill health, disability, and (c) social assistance and welfare schemes; among others (Ali and Zhuang, 2007). Financial safety net, a new concept in broader safety net definition, is emerging as an important pillar of social safety net, particularly at the time of financial and economic crisis.

  Financial services are importanat to carry on social protection, as micro finance could help in income and job protection, credit guarantees and micro insurance of business (like crop and livestock insurance) for business protection, thus protecting the poor from business failure, loan delinquences or indebtedness. Deposit insurance which was often been negated on moral hazard ground works through the promotion of financial inclusion by reinforcing confidence in financial institutions and potentially leading to more savings among the poor. Access to deposit insurance should provide a measure of protection to small savers, provided they are informed about safe places to store their money. Many deposit insurance systems include as a public policy goal, thus protecting small depositors at times of financial crisis. The provision of financial life line (minimum financial service like liquidity and credit provision) becomes a crucial at the time of market failure.

Role of the State Regulators: There exists greater coordinating role of financial sector regulators. The G8 countries have vowed for a broad-based government commitment to financial inclusion to alleviate poverty as the first principle for innovative financial inclusion. The government proactive approach is thus needed in (a) addressing the policy and regulatory framework, (b) harnessing the national and international funds for inclusiveness, (c) developing safety nets mechanisms and institutions, (d) encouraging broad based participation from industrial and financial sectors to the rural sector, (e) strengthening data management literacy programs, and (f) ensuring coordination with all the stakeholders that are vital for inclusive growth.

The coordination principle requires creating an institutional environment with clear lines of accountability and enforcement within the government and among regulators, and also encouraging partnerships and direct consultation across government, business, and other stakeholders.All this taken together would thus result in a stronger form of inclusive finance which would contribute to achieving inclusive growth.

3. Reengineering the Financial Sector for Inclusive Growth: Need for a Financial Sector Development Strategy

From the discussion in the previous sections, it is clear that there is a need to reengineer the financial sector for inclusive growth. This includes the re-orientation of central bank roles and responsibilities including the setting of monetary and financial policy objectives, choosing policy instruments and focussing on specific services that are more inclusive. There is also a need to think over the actors of development finance. As experience shows, while states have often malfunctioned in financial service delivery, the private sector has been exclusionary mostly in the access to such services at affordable price or cost. This has created a space for community and cooperative organizations to deliver affordable and accessible financial services to the poor. The role of state as a facilitator to these organizations would be crucial.

The legal (such as single objective), regulatory (such as overly focus on financial stability than on access) and operational aspects (such as letting the market to credit concentration, emphasizing collateral based lending practices, overlooking perverse incentives in banking) of the central banking may call for a revisit if we are trying to reengineer the financial system. More to that, the services of other financial institutions including the deposit taking, insurance and capital market ones have to be reworked out for making such services effectively and easily available to a wider spectrum of the society.

No doubt, controlling consumer price inflation would continue to the top most priority of central bank. But asset price bubbles created by excess liquidity injection are equally damaging to the economy and people at large. Both price increases will leave those who rely on wages and salaries, as well as those without wealth in the form of physical and financial assets, relatively worse off. Especially, credit expansion without the corresponding rise in the productive capital stock will exacerbate the distributional impact of asset price increases and raise the cost of financial intermediation.

While discussing the need for a financial sector development strategy that caters inclusive growth with stability, it is necessary to set defined roles and responsibilities of different stakeholders of the financial system. One key stakeholder which often comes on debate is the state and its role in the financial system. While the past has

seen state led financial development in several countries and also the state led rescue of the financial crisis, a credible financial sector development strategy calls for a balanced role of the state in financial market. So would be the role of global oversight and policy advisory agencies like the Fund and the Bank. Due recognization must be given to the grass root community and cooperative organizations which provide financial services to those who are left out by the large financial service providers. While shadow banking contributes a lot towards access to inclusive finance, it may also be a source of financial instability if it is deeply interconnected with the formal financial system. A credible financial sector development strategy will have to consider the regulatory and supervisory framework of such agencies, ensure their good governance, and reduce the risk of spillover effect of shadow banking friction to the formal financial sector.

The private sector market players have often worked irrationally implying that often regulators have to properly oversee and guide the market , if necessary. As invisible hand of the market would also be the invisible cause of the financial crisis, new norms for market discipline and oversight by the national and international regulators and oversight agencies have to come in public discourse, of course not limiting this among the larger economies.

Financial market imperfections such as asymmetric information and costs associated with transactions and contract enforcement affect the poor and small-scale entrepreneurs severely, as they do not have collateral, credit histories orconnections. These obstruct capital from flowing to poor individuals, even if they hold projects with high prospective returns, thus reducing the efficiency of capital allocation and aggravating inequality. By addressing these imperfections and generating enabling conditions for financial markets and instruments to develop—such as insurance products that facilitate adjustment to shocks—financial sector regulators can, therefore, not only spur growth but also help ensure that it is distributed more evenly.

While there is scanty evidence that empowering regulators augments bank stability, it has been exhibited that regulations and supervisory practices that force accurate information disclosure and promote private sector monitoring boost the overall level of banking sector and stock market development (Barth, Caprio and Levine, 2006). On the other hand, little significant impact of regulatory and supervisory practice on financial development of low-income countries is also observed (Detragiache, Gupta and Tressel, 2005).

Various researchers provide lessons on which financial regulatory strategies enhance inclusive finance and which policies obstruct it (Beck, Levine and Levkov, 2010 and Houston, Lin and Ma 2010). They pay attention on the value of regulations and supervisory practices that foster competition and transparency and that continuously

seek to eliminate policies that create incentives for financiers to undertake socially harmful—though privately profitable—investments. Such regulatory practices raise the quality of financial services, lower the cost of those services, deter corruption in credit allocation and exert a disproportionately significant impact on the living standards of lower income households. A regulatory strategy focused on competition, transparency and incentives has the advantage of fostering a sustainable inclusive growth. Such experiences are the building blocks of the financial sector strategy serving for inclusive growth.

In aggregate, the following considerations may act as a guide for reengineering the financial sector which serve the poor as well as promotes inclusive growth:

- The setting up of tiered regulatory structures can help calibrate and tailor regulation and supervision to the specific products and services offered such as focusing of small and medium enterprises, fostering diversity in institutional models. Introduction of risk-based regulation and supervision is currently a challenge in the global context. Coordination among financial sector regulators such as the central bank, insurance and capital market authorities, state and para-state agencies which monitor shadow banking and micro finance has to be in place.
- Enhancing the supervisory capacity for adequate supervision of a large number of small institutions (which may necessitate setting up a supervisory Second Tier Institution) is important, taking into consideration the expansion of financial institutions and financial innovation that is taking place at the retail financial level. A decentralized or delegated supervisory set up will prevent the central bank from overstretching itself to micro-business. It is unsafe to promote market entry without the necessary supervisory tools and the capacity to apply them to monitor new (and old) market participants.
- Including access to finance in banking regulations and supervisory practices denotes that the two traditional aims of prudential regulation—safety of funds deposited in regulated financial institutions and the stability of the financial system—need to be supplemented by a third goal of achieving universal access to financial services. This also includes incorporating the informal market/shadow banking system, such as cooperatives. There should also be efforts for identifying and removing hurdles to financial access—including those that restrain competition—without directing particular outcomes.
- Expanding credit availability by promoting rural finance, ensuring that regulations (such as loan classification criteria and capital requirements) do not discriminate against the provision of finance to the rural poor, extending micro-credit,

promoting credit information sharing, and developing venture capital markets would largely expand credit availability (Balakrishnan et.al, 2013). There is also a need for changing financing norms and practices (i.e. redefining collateral criteria, shift from collateral based to project based lending, easing banking language, etc).

- Increasing access to savings accounts and other financial services will lead to the poor getting financial security and safety nets, managing risks against shocks and also investing in new business opportunities. In this light, there is a need to scale up the financial service network including exchange and remittance services, and payment and settlement system appropriately so that its benefits are ensured thereby contributing to greater financial inclusion. But we need to be clear that access to bank accounts do not necessarily ensure inclusive growth; access to credit and other financial services are more important. Ignoring this fact, we may be too tokenist in financial inclusion policy.

Overall, there exist a number of policies that support or obstruct financial inclusion. Growth with equity policies attempt to foster economic growth and strengthen opportunities for poor and low-income people to raise their income and build assets. A macroeconomic policy structure with excessive government deficits too often crowds out credit to the private sector just as an exceptionally tight macroeconomic policy too often chokes off private demand for credit and economic growth. General institutional weaknesses in a country can impede its development, wider inequality and invite financial crisis. On some instances, governments should intervene directly in the economy and the financial system to protect the public. At other times, they can be most effective in protecting the public by promoting competition and transparency among private entities. This implies promoting competition by facilitating entry of new competitors and maintaining a diversity of types of financial service providers.The above discussion suggests that the reengineering of the financial sector needs more directed guidance from the state.

For giving guidance to the financial sector, several countries have developed financial sector development strategy. After the financial crisis and particularly amid the growing discussion on how to ensure inclusive growth, the role of finance has drawn all of our attention. Coming to a common framework for a financial sector strategy that serves towards inclusive growth would not be an easy job, but on going discourse should guide us to a tailor made approach to formulate such a strategy.

4. Nepal's Experiences on Inclusive Finance

Nepal is encountering challenges for inclusive growth which could be supported also by financial inclusion. The majority of the people are still outside the boundary of formal banking services. Although there has been a significant increase in the number of banking in service in the rural areas, it is not proportional to the large population living in these areas. In this respect, Nepal Rastra Bank's monetary and financial policies, in addition to giving due emphasis on macroeconomic and financial stability, is oriented to support inclusive growth through its credit policy and financial access strategy. Allocation of bank credit has been encouraged to promote agriculture (which provides jobs and livelihood to two-thirds of the households) and energy which is so critical for inclusive growth. There is a deprived sector lending requirement for banks and financial institutions, special refinance facility to cottage and small industries, and enterprises run by women and specified community, refinance facility with concessional interest rate to productive sector, and interest free loan to banks to open branches in rural areas. Financial literacy programs are directed towards financial inclusion and inclusive growth.

The NRB has taken following measures to enhance financial access, namely:

- Licensing of microfinance institutions in underserved areas is encouraged while the licensing for banks and other financial institutions is on moratorium.
- Interest free loan up to Rs. 10 million is provided to financial institutions for opening up new branch in specified district with inadequate financial access.
- Branchless and mobile banking in rural areas is encouraged.
- Financial literacy programs are being carried out through audio -visual and print media.
- Oversight of saving and credit cooperatives has been done to support the state regulator in widening financial services.

The NRB is also aware of the importance of credit policy. In this regard, the Bank has issued certain directives:

- Commercial banks, development banks and finance companies are required to provide 4.5 percent, 4 percent and 3.5 percent of total credit to deprived sector respectively.
- Banks and financial institutions are required to extend 20 percent of their credit to productive sectors (agriculture, energy, tourism and small & cottage industries) comprising at least 12 percent in agriculture and energy sectors. Development banks

and finance companies need to submit a plan to extend 20 percent of their total credit to productive sector in the next 3 years.

- To ease availability of credit to productive sectors, banks and financial institutions are restricted to extend more than 25 percent of their total credit to real estate sector including housing.
- Special refinance facility with very low interest rate (1 percent) for loan extended by banks and financial institutions to cottage and small industries, enterprises run by women and small enterprises run by people of specified communities
- Refinance facility is being provided to banks and financial institutions at concessional interest rate against good loan extended to productive sector.
- Microcredit facility is being provided to rural people on concessional interest rate from Rural Self Reliance Fund (created by the government and the Bank) along with interest subsidy to good borrowers.
- Refinance facility is provided to banks and financial institutions for small & medium enterprises' loan up to Rs. 10 million.
- Project loan up to Rs. 0.5 million extended by banks and financial institutions to enterprise run by women entrepreneurs is counted in deprived sector loan and refinance facility is provided to BFIs against such loan.
- Banks and financial institutions are allowed to extend project loan up to Rs. 10 million in agriculture farming such as coffee, tea, orange, livestock and dairy products on the basis of viability of the projects.
- Steps are taken to extend some amount of collateral free loan to small farmers and business enterprises.

Other regulators have also issued directives related to capital market and insurance which are inclusive in nature. They include the following:

- Access to equity participation of local community in hydropower projects.
- Deposit insurance for small depositors of up to Rs. 0.2 million.
- Mutual funds catering financial instruments to the small savers.
- Mandatory crop and livestock insurance service for the farmers.
- Wider participation of the people in the equity of financial institutions.

The NRB is aware that the financial sector has broadened, and in this regard is taking measures to enhance coordination with other regulators such as the following:

- It is working together with government agencies and other regulatory bodies of financial sector such as Insurance Board, Security Exchange Board of Nepal, and Cooperative Department to promote financial inclusion.

- For this, a “High level Financial Sector Coordination Committee” has been established and is being chaired by Honorable Finance Minister in which NRB Governor and head of other regulatory agencies are members.

Overall, in order to safeguard financial stability, increase in access to finance and facilitate in achieving inclusive growth through development and expansion of financial sector, formulation of a financial sector development strategy is in progress in coordination with the Government of Nepal and other relevant stakeholders. Support of the World Bank and IMF is being mobilized for this purpose. Financial Sector Assessment Program to begin soon would be instrumental in this regard.

5. Conclusion and Observations

Evidence suggest that the financial sector, if left alone to the free market, not only may leave large section of society out of financial services but also may heighten inequality by adversely affecting the quality of economic growh. Thus, there is a need for steering its development pathway through a financial sector development strategy to optimally contribute to inclusive growth. To realize the objective of financial inclusion, financial services for poor and low-income people should be viewed as a vital and integral component of the financial sector. This sector should include a gamut of financial institutions, each with its own comparative advantages.

This paper has raised a number of issues for further discussions among the state actors in order to alleviate poverty through inclusive growth mechanism. Some important points for discussions are as follows:

(a) How can the state or the market promote financial sector development that supports growth and reduces inequality, with adequate financial and economic stability?

(b) What would be the key financial market regulatory strategies that foster inclusive finance to promote 'good' economic growth?

(c) How is it possible for state actors (such as the Central Bank or Monetary Authority) to bring about a more inclusive financial sector that leads to broad-based financial sector development?

(d) How can access to financial services be expanded and deepened until the financial sector can be called “inclusive”?

(e) How can the global and regional financial architecture support the kind of financial system the emerging and low income economies of our region are looking for?

The above issues and discussions suggest that distribution of income and economic opportunities is very important for inclusive growth. The State can potentially play an important role in the distribution of economic opportunities through policy and programs, and in creating an enabling environment for other stakeholders, including the financial sector, to participate in the process of reducing poverty and improving equality. The financial sector, through inclusive finance mechanisms, can definitely contribute to economic growth, inclusive and sustained, as it offers appropriate and affordable financial services to the people to help them generate economic activities and improve their welfare. It is acknowledged that there are constraints for inclusive finance, both in demand and supply sides. The importance of developing safety nets mechanisms is also recognized for the sustainability of inclusive growth. In this regard, the degree of regulation of the financial sector is a challenge for state actors. Reengineering the financial sector that supports inclusive growth calls for concerted efforts at the national and international levels.

There is a diversity of financial institutions in the SEACEN region and the experiences of countries differ. Some indicators of financial inclusion of the 19 SEACEN members are provided in the Annex. Institutions, policies and practices that do well in one country may not perform well in another. However, sharing experiences with each other would be a great advantage for countries to learn the lessons and best practices.

It is observed that financial sector development strategies for building inclusive financial sector have to be creative, flexible, and appropriate to the national situation. No one can formulate an effective financial sector development strategy in isolation. In this regard, multi-stakeholder dialogues that draw together government, central bank, regulatory and supervisory authorities, the full array of financial institutions, associations, academic experts, civil society, donors, investors and the private sector can facilitate the understanding of limitations and the development of a national strategy. Addressing the above issues and learning from the experiences of those who have achieved success will pave a way for other countries to develop their financial sector development strategy and guide the financial sector to achieving inclusive growth.

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Annex : Financial Inclusion Indicators of SEACEN Economies

	Countries	% of adults with an account at a formal financial institution*	No of deposit accounts per 1000 adults**	Number of branches per 100,000 adults**	ATMs per 100,000 adults**
1	Brunei Darussalam	-	2188.49	22.22	90.53
2	Cambodia	3.67	145.64	4.38	6.66
3	China, P.R. (Mainland)	63.82	35.89	7.72	37.51
4	Fiji	-	1059.89	10.53	36.77
5	India	35.23	1042.47	11.38	11.21
6	Indonesia	19.58	708.12	9.59	36.47
7	Korea, Republic of	93.05	4884.75	18.41	-
8	Lao PDR	26.77	-	2.71	12.92
9	Malaysia	66.17	2305.31	19.91	52.94
10	Mongolia	77.72	3829.09	68.82	45.10
11	Myanmar	-	144.22	1.89	0.09
12	Nepal	25.31	451.41	8.43	7.50
13	Papua New Guinea	-	202.49	1.88	8.45
14	Philippines	25.56	497.57	8.13	19.31
15	Singapore	98.22	2180.57#	9.76	58.12
16	Sri Lanka	68.53	-	17.49	15.41
17	Taiwan	87.31	-	-	-
18	Thailand	72.67	1468.10	11.77	84.16
19	Vietnam	21.37	-	3.18	21.16

* and ** refer to the data of 2011 and 2012 respectively.
# stands for number of depositors per 1000 adults.
Source: World Bank (2011) and International Monetary Fund (2012).