Financial inclusion and economic growth: What do we know?

By Joshua Y. Abor, Haruna Issahaku, Mohammed Amidu and Victor Murinde
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Financial inclusion and economic growth: What do we know?\(^1\)

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Abstract

The financial inclusion revolution is on. In this paper, we survey the new and expanding research on financial inclusion and the link between inclusive financial development and economic growth. We examine existing work on the conceptualisation, definition and measurement of financial inclusion, plus a description of the trends. We summarise the evidence so far on the determinants of, and barriers to, financial inclusion. We also assess the research findings on the link between inclusive finance and financial development, but further look into the effect of inclusive finance on economic growth. We highlight current knowledge on the role of institutional architecture in the financial inclusion-economic development nexus. We offer some concluding remarks, on the way forward for supporting financial inclusion in developing countries, such as the role of institutional quality, infrastructure and enabling policies.

**Keywords:** inclusive finance; financial inclusion; financial development; economic growth

**JEL Classification Nos:** G01, G21, G28

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1. Introduction

The financial inclusion revolution is on. Arguably, there are at least three motivations for examining the effects of financial inclusion on growth: the very low level of financial inclusion in countries which need economic growth most (low income countries), the lacklustre growth in Sub-Saharan African (SSA) in recent times, and a realisation of the role of financial inclusion in accomplishing the Sustainable Development Goals (SDGs). Each motivation is substantiated in chronological order.

First, while financial inclusion (particularly, account ownership) has almost reached a saturation point in high-income countries, low-income countries have yet to make any significant progress in ensuring financial inclusion. Meanwhile, it is these low-income economies, which need financial inclusion the most in order to jumpstart inclusive development. Based on the Findex data provided by Demirguc-Kunt, Klapper, Singer, and Oudheusden (2015), about 90.6% of adults in high income, 94% in high income OECD, have an account, while only 27.4% of adults in low-income countries own an account. Similarly, while 75.1% and 79.7% respectively of adults in high income and high income OECD countries have debit card, only 6.6% of adults have a debit card in low-income countries. This means that immense opportunities exist in poor countries for extending financial inclusion for economic development.

Second, based on International Monetary Fund (IMF) data (IMF 2018), in 2016, SSA, the poorest region in the world, experienced her lowest growth in over 20 years. From 3.4% in 2015, growth in the region fell considerably to 1.4% in 2016. Notwithstanding the fact that growth picked up in 2017 (2.7%) it was still jaded. This appalling growth is attributable to falling commodity prices, unsupportive global economic environment and structural bottlenecks in some countries in the region. In particular, resource reliant economies such as Angola, Nigeria and South Africa have bowed to the repercussions of very low crude oil prices as revenues have been severely affected. Inopportune, these are the three largest economies in the sub-region and for that matter their weaknesses spill over to other countries in the sub-region. These three economies respectively grew by 0.0%, -1.5%, and 0.3% in 2016. It is refreshing to note that some non-oil dependent economies are however performing impressively by experiencing growth in excess of 6%. These include Côte d’Ivoire, Ethiopia, Kenya and Senegal. Clearly, financial inclusion has a role to play in accelerating growth in the SSA region.

Third, financial inclusion is indispensable to the attainment of the SDGs. Consequently, financial inclusion has been integrated into the SDGs, where it features prominently as a target in eight out of the 17 SDGs. These are SDG 1: eradicating poverty; SDG 2: ending hunger, achieving food security and promoting sustainable agriculture; SDG 3: health and well-being; SDG 5: achieving gender equality and economic empowerment of women; SDG 8: promoting economic growth and jobs; SDG 9: supporting industry, innovation, and infrastructure; SDG 10: reducing inequality, SDG 17: strengthening the means of implementation. As an example, one of the targets of SDG 8 is to “Strengthen the capacity of domestic financial institutions to encourage and expand access to banking, insurance and financial services for all”. This means that the future of the world depends so much on our ability to extend a wide range of financial services to the poor and marginalised. In this wise, a more succinct understanding and vigorous pursuit of financial inclusion will be a vital contribution towards attaining these lofty global goals (SDGs).
The rest of the paper is structured as follows. Section 2 defines financial inclusion and provides a guide to its measurement. Section 3 describes the trends in financial inclusion. Section 4 discusses the determinants of and barriers to financial inclusion. Section 5 assesses the link between inclusive finance and financial development. Section 6 examines the effect of inclusive finance on economic growth. Section 7 discusses the roles of institutional architecture in the financial inclusion-economic development nexus. Section 8 concludes the paper.

2. Conceptualising Financial Inclusion

Financial inclusion, an antidote to financial exclusion, has become a buzzword in policy, academic and practitioner circles. However, conceptualising financial inclusion remains an unsettled matter. While there is almost a consensus on the definition of financial inclusion, the issue of measurement remains unsettled. Allen, Demirguc-Kunt, Klapper, and Peria (2016) define financial inclusion simply as “usage of formal financial services” (p.2).

The World Bank defines financial inclusion as the case where “individuals and businesses have access to useful and affordable financial products and services that meet their needs – transactions, payments, savings, credit and insurance – delivered in a responsible and sustainable way” (http://www.worldbank.org/en/topic/financialinclusion). For the African Development Bank (AfDB), 2012) financial inclusion means “all initiatives that make formal financial services Available, Accessible and Affordable to all segments of the population” (p. 26). According to the Centre for Financial Inclusion, financial inclusion is a “state in which everyone who can use them has access to a full suite of quality financial services, provided at affordable prices, in a convenient manner, with respect and dignity” (http://www.centerforfinancialinclusion.org/). Diniz, Birochi and Pozzebon (2012) views financial inclusion as making formal financial services accessible and affordable to all individuals, especially those with low incomes. Based on these definitions, we present a broad (‘consensus’) definition for financial inclusion as follows.

Financial inclusion can be defined as eliminating obstacles to financial products and services (such as credit, investment, savings, insurance, financial technology and payments) for everybody in the economy (rich or poor, male or female, rural or urban dweller, educated or uneducated) and establishing a platform, or framework, or a system which produces low cost, fair, convenient, safe, quality and sustainable financial services and products, and facilitates access to and usage of these products and services by all, at all times.

In terms of measurement, most empirical studies measure financial inclusion using one or more single variable measures such as ownership of bank account or number of accounts per 1000 adults, number of bank branches per 100,000 adults, savings capacity, insurance penetration among others. But these single variables measures have been criticised for being too narrow to convey the multidimensional nature of financial inclusion. Now, the trend in the literature is to construct a financial inclusion index based on some identified dimensions. Sarma (2012) constructs a financial inclusion index with three main dimensions namely penetration, availability and usage of financial services. In a similar vein, the Financial Inclusion Data Working Group of the Alliance for Financial Inclusion [(AFI FIDWG), 2012] has proposed three dimensions of financial inclusion: Access, Quality and Usage.
Access refers to availability of formal financial services in terms of physical proximity and affordability.

Quality entails designing and customising financial services to the satisfaction of consumers.

Usage refers to regularity, frequency and duration of usage of financial services.

However, it may be argued here that cost considerations constitute a fourth dimension of financial inclusion indicators. The argument here is that households and firms are excluded from formal financial institutions and markets purely on the basis of high costs, both pecuniary costs and transaction costs.

A more succinct (and universal) view of financial inclusion in three dimensional form has been provided by Hall (2014). The components of Hall’s three dimensional view of financial inclusion (FI3D) are Financial Participation, Financial Capability, and Financial Well-Being. Each dimension embodies several sub dimensions.

**Financial Participation** refers to the affordability, access to and usage of formal financial services and products (accounts, credit, deposits, investment, insurance, financial technology, payments).

**Financial Capability** measures the ability of financial inclusion to enhance the capability of the individual to effectively participate in the formal financial system. It entails the ability of the individual to make prudent financial decisions, effectively undertake financial planning and budgeting, and be financially literate and keep up to date with financial innovations and trends.

**Financial Wellbeing** measures the degree to which financial inclusion has improved the quality of life and wellbeing of the individual. It measures financial inclusion induced improvements in financial quality of life, amelioration of hardship, curtailment of over-indebtedness, financial self-sufficiency, and livelihood sustainability.

Thus, Hall’s conceptualisation collapses the three elements of financial inclusion proposed by AFI FIDWG (2012) (access, quality, usage) into one broad dimension, financial participation.

### 3. Trends in Financial Inclusion

Compared to the rest of the world, financial inclusion is very low in SSA (Table 12.1). However, the trend sows improvement. The percentage of adults who had any form of account in 2017 was 68.5% globally compared to 42.6% in SSA. Again, while 62% of adults aged 15 and above had any form of account in 2014 globally, only 34.2% had an account in SSA in the same period. Globally, the percentage of adults with account increased from 50.6% in 2011 to 68.5% in 2017. Similarly, in SSA, the percentage of adults with account increased from 23.2% in 2011 to 42.6% in 2017. Unfortunately, vulnerable groups such as women, the unemployed and the poor have the lowest incidence of financial inclusion (in terms of ownership of account) both in the world and SSA.

The incidence of financial inclusion is lower with respect to accounts with formal financial institutions. While the percent of adults with account in a formal financial institution increased from 50.6% in 2011 to 67.1% in 2017 worldwide, in the case of SSA, the same increased from 23.9% in 2011 to 32.8% in 2017. This highlights that the growth in global trend in formal account ownership is faster than that of SSA. Thus, efforts have to be doubled to extend basic financial accounts to the unbanked in the region.
In the academic, policy and practitioner circles, more value is placed on usage of account than mere ownership of account as somebody may have an account but the account has been dormant for months or years. SSA has a higher proportion of adults with dormant account compared to the global average. The percentage of adults who neither deposited nor made withdrawal from a financial institution account in 2017 was 13.7% for world and 7.1% for SSA. There is an upsurge in the utilisation of digital financial services. Globally (SSA), the proportion of adults who received or made digital payments increased from 41.5% (26.9%) in 2014 to 52.3% (34.4%) in 2017, an increase of about 10.8% (7.5%) over the four-year period. Generally, SSA lags behind the global average with respect to account usage indicators such as receipt of wages and government transfers through formal account, use of account to pay bills, and making online transactions. This is largely due to the relatively large informal sector in the region which encourages payments through informal channels. The share of Africa’s informal sector in GDP is 38% compared to 24% of GDP for Europe. This means that formalization can be a key driver of financial inclusion.

Table 1. Trends in Financial Inclusion: SSA and the World

<table>
<thead>
<tr>
<th>Financial Inclusion Measure</th>
<th>SSA</th>
<th>World</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Account (% age 15+)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>All adults, 2017</td>
<td>42.6</td>
<td>68.5</td>
</tr>
<tr>
<td>All adults, 2014</td>
<td>34.2</td>
<td>62</td>
</tr>
<tr>
<td>All adults, 2011</td>
<td>23.2</td>
<td>50.6</td>
</tr>
<tr>
<td><strong>Financial institution account (% age 15+)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>All adults, 2017</td>
<td>32.8</td>
<td>67.1</td>
</tr>
<tr>
<td>All adults, 2014</td>
<td>28.8</td>
<td>61.2</td>
</tr>
<tr>
<td>All adults, 2011</td>
<td>23.2</td>
<td>50.6</td>
</tr>
<tr>
<td><strong>Mobile money account (% age 15+)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>All adults, 2017</td>
<td>20.9</td>
<td>4.4</td>
</tr>
<tr>
<td>All adults, 2014</td>
<td>11.6</td>
<td>2.1</td>
</tr>
<tr>
<td><strong>Account, by individual characteristics (%)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Women</td>
<td>36.9</td>
<td>64.8</td>
</tr>
<tr>
<td>Adults belonging to the poorest 40%</td>
<td>31.9</td>
<td>60.5</td>
</tr>
<tr>
<td>Adults out of the labour force</td>
<td>31.4</td>
<td>59.3</td>
</tr>
<tr>
<td>Adults living in rural areas</td>
<td>39.5</td>
<td>66</td>
</tr>
<tr>
<td><strong>Digital payments in the past year (% age)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Made or received digital payments, 2017</td>
<td>34.4</td>
<td>52.3</td>
</tr>
<tr>
<td>Made or received digital payments, 2014</td>
<td>26.9</td>
<td>41.5</td>
</tr>
<tr>
<td>Used an account to pay utility bills, 2017</td>
<td>7.7</td>
<td>22.3</td>
</tr>
<tr>
<td>Used an account to receive private sector wages, 2017</td>
<td>5.7</td>
<td>15.9</td>
</tr>
<tr>
<td>Used an account to receive government payments, 2017</td>
<td>7.3</td>
<td>16.3</td>
</tr>
<tr>
<td>Used the internet to pay bills or to buy something online, 2017</td>
<td>7.6</td>
<td>29</td>
</tr>
<tr>
<td>Used a mobile phone or the internet to access an account, 2017</td>
<td>20.8</td>
<td>24.9</td>
</tr>
<tr>
<td>Used a debit or credit card to make a purchase, 2017</td>
<td>7.5</td>
<td>32.6</td>
</tr>
<tr>
<td><strong>Inactive account in the past year (% age)</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>No deposit and no withdrawal from an account</td>
<td>5.5</td>
<td>13.4</td>
</tr>
<tr>
<td>No deposit and no withdrawal from a financial</td>
<td>7.1</td>
<td>13.7</td>
</tr>
<tr>
<td><strong>Domestic remittances in the past year (%)</strong></td>
<td></td>
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</tbody>
</table>
One of the important indicators of financial inclusion is savings. The seminal work in the Harrod-Domar model highlights how the accumulation of savings can help a nation to realize its growth potential. Savings is important because it is the building blocks for investment. And without investment, no significant economic progress can occur. Globally, the proportion of adults who save in a financial institution is very low and the trend is showing stagnation. Worldwide, the percent of adults who saved with a financial institution increased from 22.6% in 2011 to 27.4% in 2014 and dropped to 26.7% in 2017. Meanwhile, in SSA the percent of adults who saved with a financial institution increased marginally from 14.3% in 2011 to 15.9% in 2014 and declined slightly to 14.9% in 2017. Thus, though formal savings rate in SSA lags behind the global figures, the savings rate is stagnating both worldwide and in SSA. Some barriers to formal savings include distance to financial institution and low interest rates on savings. Formal savings is emphasized as opposed to informal savings because of the many risk involved in informal savings mechanisms and the ability for formal savings to generate several other deposits through the deposit multiplier.

Though it is well recognized that credit is indispensable to the growth of enterprises, access to credit remains an intractable problem worldwide. Globally, the percent of adults who borrowed from a formal financial institution or used a credit card was 22.5% in 2017, from 22.3% in 2014. Similarly, in SSA, the percent of adults who borrowed from a formal financial institution was 8.4% in 2017, from 7.5% in 2014. Informal sector firms suffer the most when it comes to accessing finance due to a wide range of issues including but not limited to lack of usable collateral, lack of valid business registration documents, distance to financial institutions and low level of financial literacy.
4. **Determinants of, and Barriers to, Financial Inclusion**

The empirical literature documents a number of factors as determinants of, or barriers to, financial inclusion. We discussed these as follows.

**Inadequate and lack of supportive infrastructure.** Infrastructure such as transportation, energy, communications and finance are needed to provide quality financial services to a large number of people. Meanwhile, these infrastructure are either lacking, or are inadequate or are in poor condition in most developing countries and in rural areas in particular. Financial institutions are unwilling and unable to set up outlets in areas where such key infrastructure are lacking. That is why it is unsurprising that financial inclusion rates are lowest in rural and economically disadvantaged settlements. Globally, the amount needed to meet infrastructure needs by 2040 is estimated at $94 trillion (Global Infrastructure Hub, 2017). Though Asia has the largest investment need (needing about 50% of overall global infrastructure, Africa and the Americas are forecast to have the largest infrastructure gap. The infrastructure investment gap in these regions are estimated at 28% and 32% respectively of investment need. Africa’s infrastructure investment gap widens to 43% when infrastructure needed to meet the SDGs are incorporated. Putting in place supportive infrastructure will help extend financial inclusion to millions.

**Deterrant transaction costs.** Costs of obtaining information and enforcing contracts are prohibitive in a number of poor countries. Financial institutions often find it very expensive to provide financial services to poor individuals who are often located in deprived areas where transaction costs are high. The poor state of infrastructure or the lack of it exacerbates transaction costs. Banks and other financial institutions are therefore more comfortable to deal with rich individuals, large firms and government than bank with the poor who are often classified as ‘unbankable’. Digital finance provides an avenue for reducing the cost of extending finance to the poor. It is estimated that, mobile payments can lower the cost of providing financial services by 80 to 90 percent, enabling providers to serve lower income customers profitably (McKinsey & Company, 2016).

**Low level of general literacy and financial literacy.** Though there are improvements in literacy on the whole, about 774 million adults cannot read and write representing one fifth of the global population (Carr-Hill & Pessoa, 2008). This represents a waste of potential human capital and economic productivity capacity. Most of these non literate adults are concentrated in South and West Asia, SSA, and East Asia and the Pacific and they are mostly women. In terms of geography they are mostly located in rural areas. Such high levels of illiteracy dovetail into poor decision making and lack of capacity to take advantage of opportunities including financial inclusion related opportunities. Even though financial literacy is more of a problem to the non literate, it is a problem for the literate as well. Low level of financial literacy leads to wrong financial choices, poor financial planning, unnecessary risk taking, low utilisation of financial services and products among others.

**High poverty rates.** Accessing and using financial services often does not come free or cheap. For instance some minimum amount is often required to open an account even though now some banks have instituted no frill accounts. In terms of digital financial, at least one must be able to afford a phone or other electronic device in other to enjoy digital financial services. This means that in areas where poverty is prevalent, financial inclusion is likely to suffer. Unsurprisingly, financial
inclusion penetration rates are lowest in low income countries than in high income countries. Thus, reducing poverty can remove an important roadblock to financial inclusion. The Findex database 2018 shows that, in all cases and in all regions of the word, adults belonging to the poorest 40% of the population are on the average less likely to own an account. For instance, while 70.6%, 65.3%, 54.4%, 43.5%, 69.6%, and 42.6% of all adults, respectively in East Asia & Pacific, Europe & Central Asia, Latin America & Carribean (LAC), Middle East & North Africa, South Asia, and SSA has any form of account, 59.3%, 56.3%, %41.9%, 35.3%, 65.6%, and 31.9% of the poorest 40% respectevly has an account in these regions.

**Dispersed population.** Settlements in rural and less populated areas are often dispersed and this increases the cost of providing financial services to these areas relative to return on capital employed. SSA has the lowest population density in the world with an average population per square kilometer of 40 overall and 14 in rural areas (World Bank, 2014).

Apart from the determinants discussed above, there are some individual level characteristics and societal level factors which impede financial inclusion. These include age, gender (women are less likely to be financially included) at the individual level, and religion, culture, law and order at societal level factors. Other barriers to financial inclusion include documentation requirements, trust issues. Dasgupta (2009) summarises the determinants of financial exclusion as follows:

(i) Geographical - i.e., non-existence of branches in an area,
(ii) Access exclusion – i.e., restricted access because of bank’s risk assessment process,
(iii) Condition exclusion - i.e., conditions related to products failing to meet needs,
(iv) Price exclusion - i.e., charges associated with products or services are very high,
(v) Marketing exclusion - i.e., strategic exclusion of certain products,
(vi) Self-exclusion - i.e. some sections of the population refuse to approach banks, believing that any request will be turned down. (p. 41).

5. **Inclusive Finance and Financial Development**

Much ink has been spilt over the nexus between financial development and economic growth (see, for example, Murinde, 2012). While the jury is still out there regarding the nexus, the emphasis by policy makers and researchers has shifted from financial development to financial inclusion. The shift can be attributed mainly to the fact that financial development has not brought about drastic changes in livelihood and has also excluded so many poor people from the formal financial system. Not only is financial inclusion good for welfare, it also has the capacity to promote financial development, particularly financial stability. Financial inclusion enables the poor and low income earners who have more stable savings and borrowing appetite to participate in the formal financial system. In times of crises deposits from retail clients serve as a more stable funding source for banks in contrast to wholesale funding sources, which cease during crises periods (Neaime and Gaysset, 2018).

Furthermore, financial inclusion enables banks and other financial institutions to discover new business areas by reaching out to a vast majority of the unbanked and underbanked in developing countries. In this regard, financial inclusion enables banks to diversify across locations, financial products and services and income group. This enhances the resilience of financial markets and institutions. Again, financial inclusion increases the efficiency of monetary policy by increasing
the number of participants in the formal financial system thereby increasing the scope for monetary policy. A more financially included economic environment ensures that monetary policy signals are effectively transmitted to the real sector. This is contrasted with financial development where few people are in the formal financial system impeding the flow of monetary signals to the real sector. Also, by bringing a lot of previously unbanked and underbanked customers closer to the formal financial system, financial inclusion ameliorates information asymmetry allowing banks to roll out cost effective financial models (Ahamed, Mostak, Mallick, and Sushanta, 2017). This reduction in information asymmetry reduces financial vulnerability by improving loan recovery and while reducing bank’s bad loan portfolios.


Box 1: The dark side of financial inclusion

“So far, we have focused on the ‘bright side’ of financial inclusion. Unfortunately, there can be a dark side too. Partly in response to the Global Crisis – and also inspired by Raghu Rajan’s 2005 Jackson Hole paper – a growing body of research questions whether finance is always good for growth, suggesting that ‘too much’ or ‘too fast’ finance can plant the seeds of future financial crises (Arcand et al. 2015, Gourinchas and Obstfeld 2012, Mian and Sufi 2014, Schularick and Taylor 2012). This vulnerability is not an exclusive feature of financial markets in advanced economies. During the microcredit crisis in India in 2010 the state government of Andhra Pradesh, worried about widespread over-borrowing and alleged abuses by microfinance collection agents, issued an emergency ordinance, bringing microfinance activities in the state to a complete halt. This large contraction in microcredit supply translated into large negative effects on the labour market and on consumption (Breza and Kinnan 2018). More recently, the assessment of the JDY programme in India presented by Agarwal et al. (2018a) also shows evidence of an increase in loan defaults in areas more exposed to the programme, pointing to the trade-off between inclusion and stability”.


The empirical literature supports the financial sector stabilising role of financial inclusion. Ahamed et al. (2017), studied the impact of financial inclusion in 2,600 banks across 86 economies over the period, 2004 - 2012. They found that financial inclusion promotes financial stability especially in banks that have significant customer deposit profile and those with smaller marginal cost of delivering financial services, and in banks operating in countries with better institutional quality. In a sample of MENA region over the period, 2002 - 2015, Neaime and Gaysset (2018), found financial inclusion to boost banking sector resilience by stabilising the deposit funding base in the region. Using a panel of 97 countries over the period, 2004 - 2012, Rasheed, Law, Chin, and Habibullah (2016) similarly found financial inclusion to positively influence two indicators of financial development: credit to private sector and stock market turnover ratio.

Thus, the empirical evidence largely dispels one of the notions that banks have, which prevents them extending finance to the poor: financial inclusion will disrupt the soundness of the financial
Notwithstanding the evidence in support of the ability of financial inclusion to foster financial, there is still a section of the literature which argues that financial inclusion can increase the vulnerability of the financial system by bringing into the banking system those individuals and business that are high risk borrowers (see Box 1 for more on this argument).

6. Inclusive Finance and Economic Growth

We first look at the transmission channels between financial inclusion and economic growth and discuss the empirical literature on the financial inclusion and inclusive growth and development.

6.1 The Financial Inclusion-Economic Growth Transmission Channels

Theoretically, financial inclusion can promote economic growth and development through the following channels.

*Capital accumulation:* financial inclusion promotes the accumulation of savings in the banking system and in other financial intermediaries. These savings serve as capital for investment in productive ventures. Again, these savings deposits are transformed into loans and other financial products to support the investment plans of deficit spending units. The savings triggered by financial inclusion is broad based and ensures the mobilisation of resources from economic units (rural and poor households) that were otherwise considered unable to save.

*Innovation and entrepreneurship:* the quality of human capital is an indisputable precursor to economic growth. Meanwhile, the quality of human capital determines the degree of innovation and entrepreneurship in an economy. And financial resources are critical to the training and capacity development of human capital. Households and SMEs that are financially included are more able to find the financial resources to fund their education and training needs than their counterparts who are excluded from the formal financial system. Even in situations where individuals cannot pay education fee out of pocket an inclusive financial system will enhance access to affordable credit and other avenues of support be they private or governmental. Financial inclusion provides new, affordable and convenient means of payment of school fees. The well-trained work force is able to generate inventions and bring innovative solutions to societal problems. Such new inventions and innovations bring about drastic increases in output and economic growth. Financial inclusion spurs entrepreneurship by providing access to capital, stimulating financial literacy and imparting business management skills to individuals who otherwise would have been deprived of opportunities to live their dreams owing to financial exclusion.

*Income and employment:* financial inclusion provides business and employment opportunities for individuals, households, financial institutions and government. Financial inclusion provides both direct and indirect employment. Let us take mobile money services as an example. As at 2014, the M-PESA intervention had directly employed at least 180,657 mobile money agents in Kenya as at June 2017, from 129,357 as at June 2016. These agents provide withdrawal and deposit services. Similarly, in Ghana, as at 2016, there were 107,415 active mobile money agents across the country, up from 56,270 active agents in 2015, a growth of 90.9% (Bank of Ghana [BoG], 2017). The indirect jobs provided by financial inclusion are more difficult to estimate but are likely to be more
than the direct jobs. Financial inclusion affords banks and other financial intermediaries opportunities to reach out to the untapped unbanked population through the opening of new branches and outlets. In doing so these financial institutions create new job openings, enhance their profitability and strengthen their position in the financial system. Entrepreneurship is facilitated in these new locations leading to improvements in the performance of SMEs. In a nutshell, financial inclusion engenders job creation both directly and indirectly, and yields income to beneficiaries therefrom.

**Opportunities for diversification:** by making funds available to a wide range of investors, financial inclusion increases the range of economic choices available to individuals, households and businesses leading to economic diversification. By helping poor people and SMEs to save and borrow, build assets, insure against the unforeseen, and make and receive payments with ease, financial inclusion enables the production of diverse goods and services, access to various markets (locally and internationally) and diversification of income sources. This increases the economic resilience of beneficiary individuals, households and businesses, and subsequently cascading into a more resilient and stable macroeconomy. Through diversification, financial inclusion serves as a risk management mechanism, reducing reliance on vulnerable sources of output, markets and income.

**Productivity:** a lot of economic agents are not as productive as they should be because of financial exclusion which makes them unable to provide the needed inputs at the required quantities at the right time to support production or take advantage of promising opportunities. With access to finance rational economic agents can employ the right quantities of labour, capital, technology and other factors in order to boost productivity. By spurring innovation and entrepreneurship, financial inclusion extends the frontier of production, making economic agents attain new productivity heights.

**Financial security:** financial inclusion opens up the range of financial choices available to the poor, enables the poor to accumulate capital over the long run, facilitates long range investment and consumption planning, and enhances the capacity of households to absorb financial shocks.

To sum up, from a theoretical perspective, financial inclusion promotes economic growth and inclusive development by enabling capital accumulation, stimulating entrepreneurship and innovation, generating direct and indirect job opportunities, promoting economic diversification, boosting productivity, and ensuring financial security.

6.2 **Empirical Evidence on Financial Inclusion and Inclusive Growth and Development**

At least since Schumpeter (1811) there has been the recognition that financial development is closely linked to economic growth. However, empirical evidence on the real effects of broad based access to finance on growth is relatively nascent. The empirical evidence generally supports a positive impact of financial inclusion on growth and development though the impact varies from no impact to moderate to large.

Evidence from India support the claim that broad based financial access fosters growth. In a study conducted between 2004-2013 and using Vector Autoregression (VAR) and Granger causality test,
Sharma (2016) concluded that various dimensions of financial inclusion promoted economic growth in that country. The granger causality test revealed bidirectional causality between geographic outreach of banks and economic growth; unidirectional causality between number of deposits/loan accounts and growth and no causality between usage of bank services and economic growth. Another study in India by Lenka and Sharma (2017) using data from 1980-2014 showed that financial inclusion has a positive effect on economic growth both in the short run and long run. This study unlike the previous, found a unidirectional causality running from financial inclusion to economic growth.

Swamy (2014) examined the economic impact of financial inclusion in India from a gender perspective. Using panel data from 2007-2012, the author found a positive gender premia of the effect of financial inclusion on income in favour of women. Specifically, financial inclusion programmes were found to increase incomes (after adjusting for inflation) of women by 8.40% compared to 3.97% for men. The authors explained that women had better awareness of financial inclusion instruments, utilised financial inclusion to improve household savings and employed financial inclusion in ways that improved welfare. Recent evidence from 55 Organisation of Islamic Cooperation (OIC) countries by Kim, Yu, and Hassan (2018) confirmed a positive impact of financial inclusion on growth using supply side financial inclusion measures such as number of ATMs per 100,000, bank branches per 100,000, number of borrowers from commercial banks per 1000, and life insurance premium volume to GDP. The study covered the period 1990-2013. In line with Sharma (2016) but unlike Lenka and Sarma (2018), Kim, Yu, & Hassan, 2018 found bidirectional causality between finance and economic growth.

Demand side data from Ghana supports a positive effect of financial inclusion on inclusive growth. First, based on the Ghana Living Standard Survey data (GLSS 6), Abor, Amidu and Issahaku (2018) documented positive effects of mobile telephony (ownership and usage) and financial inclusion (access to bank account, savings, credit and insurance) on inclusive growth measures such as poverty and real per capita consumption. However, unlike Swamy (2014), Abor et al. (2018) did not find the effect of financial inclusion on pro-poor growth to be more pronounced in female-headed households than in male-headed household. Again, they did not find the impact to be greater in rural than in urban households. Using the same dataset, Abu and Issahaku (2017) highlighted a positive impact of financial inclusion on agricultural commercialisation.

Evidence from randomised control trials offer less optimistic results of the impact of financial inclusion on development. For instance, as an introduction to the 2015 American Economic Journal: Applied Economics special issue on microcredit experiments, Banerjee et al. (2015) arrived at the conclusion that the most consistent finding from most studies is that the real effects of microcredit on poverty is modest but not transformative, even in the case of women empowerment. Borrower heterogeneity is offered as the reason for this less enthusiastic result. In line with this, Banerjee et al. (2018) have recently shown that while microcredit had a persistent effect on business activity and consumption for individuals who already had business before the intervention, the impact on beginner entrepreneurs was negligible. Another recent study in the MENA region found that while financial inclusion reduced inequality, it had no significant impact on poverty reduction in that region (see Neaime and Gaysset, 2018).

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2 Read more from: https://voxeu.org/article/financial-inclusion-drivers-and-real-effects.
Box 2: Financial Inclusion is a Sub-Saharan Success Story

“In 2014 US-based think-tank the Brookings Institution launched its financial and digital inclusion project to examine the access to and usage of secure, affordable formal financial services among the underserved populations of the world. The project has since reported twice annually on the nature and extent of financial inclusion. In its 2016 report it scores best practice in terms of country commitment, mobile capacity, regulatory environment and level of actual adoption. And it finds once more that Sub-Saharan Africa is well represented in the top 10. Kenya (84%), Uganda (78%), South Africa (78%), Rwanda (76%) and Nigeria (72%) account for half of the top 10. Indeed, Kenya takes the number one slot for the second year running, thanks to its mobile money revolution.

The Brookings report does not cover countries such as the US that are affluent generally. However, it points out that about 8% of households in the US do not have a bank account, and that these households suffer extra costs and burdens as a result, just as non-account holders do in the developing world. Sub-Saharan Africa’s people have achieved better financial inclusion mainly because of the widespread availability of cheap mobile phone networks and the adoption of mobile money platforms. The mobile operator body GSMA estimates that another 168 million Africans will be connected by mobile phone and money networks over the next five years, with the total reaching 725 million by 2020.

Innovations such as the MPESA mobile phone-based money transfer system in Kenya, which have revolutionised the lives of both the rural and urban poor, offer people alternatives that did not exist only a short while ago. Today, a phone can not only let people get hold of money in a remote rural setting, at any time of the day or night, but also let them borrow and lend, settle utility bills and loans, have their salary paid in and make deposits as well as buy goods and view detailed statements of transactions – all in much the same way as happens with traditional banks. The latest innovation is that Kenyans can pay for government services such as the renewal of licences and permits directly using their mobile phones.

Mobile phones have also empowered women, and reduced poverty by allowing social networks to be leveraged so people at the poorest level of society can borrow, help and support each other. Current trends in the mobile money industry should improve financial inclusion in this region further:

- Interoperable platforms allow individuals to use their mobile money across different operator platforms.
- New technologies such as near field payment modules will allow more people to use their phones in new ways to make and receive money.

With 725 million Africans expected to be able to connect and carry out transactions with each other by 2020, there will be substantial new internal opportunities for business as well as personal enrichment for a great many individuals. Rural farmers, for example, can now receive income from farming as well as the information they need for a better harvest next time, directly via their phones. The financial inclusion of the poor thus offers new opportunities for everyone”.

Evidence from quasi-natural experimental studies offers more encouraging results. Based on Mexican data, Bruhn and Love (2014) found financial inclusion in the form of branch expansion by banks to have considerable impact on labour market activity and income of deprived individuals and people who lived in locations that hitherto had low bank outreach. Similarly, Burgess and Pande (2005) found that, branch expansion by rural banks could explain between 14 to 17 percentage point decrease in headcount poverty in rural India.

While the literature is clear on how financial inclusion affects growth, it does not clearly explain how economic growth stimulates financial inclusion. Though not adequate explanation has been given as to how growth stimulates financial development, it is not hard to fathom how this happens. Four explanations are offered here. First, economic growth increases the capacity of the government to provide the infrastructure required for broad based access to financial services. Second, a growing economy provides the business case for banks and other financial institutions to reach out to the unbanked. Third, economic growth increases the financial capacity of banks to set up new branches and outlets, and to develop and roll out new financial services to a large segment of the population. Fourth, broad based economic growth enhances the capacity of the citizenry, including the poor, to demand various financial services to enable them meet their financial needs and plans, and to take advantage of economic opportunities.

7. Institutional Architecture, Financial Inclusion and Economic Development

Since North’s (1990) influential book “Institutions, Institutional Change and Economic Performance”, development economists have come to appreciate better the role of institutions in economic development. According to North (1990), “institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction.”(3). Institutions are vital because they provide incentives for human actions as well as the nature of these interactions and the benefits that ensue thereby. Therefore, institutions can determine the nature and extent of the impact of financial inclusion on economic growth. Some of the institutional imperatives which can enhance the growth impact of inclusive finance include strong mechanisms for control of corruption, transparent and accountable governance, protection of property rights, entrenchment of a strong merit system, effective enforcement of law and order, efficient bureaucracies, political stability, and protection of freedoms and human rights alongside a wide array of progressive habits, norms and civic values.

There are at least four channels through which institutions can enhance the effect of financial inclusion on economic development: reducing transaction costs and increasing the efficiency of exchange, determining the rate of return on investment, providing the environment for innovation and creativity, and establishing the environment for effective collaboration and mobilisation of social capital. Each of these channels is explained in turn below.

Reducing transaction costs and increasing the efficiency of exchange: institutions ameliorate transaction costs associated with information, transportation, decision-making, and bargaining. Strong institutions ensure transparency and accountability, which reduce information asymmetry associated with transactions. Institutions establish uniform standards and standardised laid down procedures to reduce red tapes and facilitate economic decision-making. Furthermore, institutions facilitate the settling of disputes arising from economic and social transactions, which enable
peaceful coexistence and the containment of fraud in transactions. Strong institutions will ensure that funds meant for road construction and such other infrastructure are not diverted for private gain. On the contrary, “Societies with weak institutions can be trapped in a low growth equilibrium fuelled by information asymmetry, coordination failures and other market imperfections” (Issahaku, Abor, and Amidu, 2018, p. 30).

Determining the rate of return on investment: institutions influence the rate of investment as well as return on investment by reducing the risk and uncertainty involved in economic transactions (by providing stable norms, standards and procedures), ensuring property rights and providing protection for investors. For instance, research has shown that when farmers have legal title to land, investment in the land and output increase (see Pande and Udry, 2005). In a number of cases, land and other productive resources have been left idle due to prolonged and wobbly dispute resolution systems perpetuated by weak institutions. Some investors have relocated from certain economies due to the inability of the system to provide protection for them and their properties, thus lowering investment. In some cases investors do not relocate but they reduce the amount of investment as a way of mitigating losses. The point being made here is that a household or an investor may have access to funds but may be unwilling to invest due to institutional constraints, or may invest but the return on the investment is reduced through institutional lapses. Moreover, weak institutions reduce the rate of return on investment by increasing systematic risks and for that matter reducing opportunities for diversification and the spreading of risks.

Providing the environment for innovation and creativity: creativity and innovation are critical fuels for human prosperity and welfare. Institutions promote creativity and innovation by providing the necessary environment for innovation and creativity to thrive. Institutions unlock creative and innovative potential by establishing the freedom to innovate and be creative, providing protection for intellectual property, promoting investment in human capital development, and ensuring the evolution of an educational system that is creativity and innovation centred. With the suitable atmosphere provided by institutions for creativity and innovation, financial inclusion can ensure the mobilisation of resources for investment in the generation of new ideas, new products and services thereby fostering entrepreneurship, growth, productivity and development.

Establishing the environment for effective collaboration and mobilisation of social capital: institutions are either extractive or inclusive in nature depending on whether they hinder or foster growth (Acemoglu and Robinson, 2012). Inclusive institutions promote growth while extractive institutions thwart growth. Inclusive institutions encourage collaborations, networking and information sharing which enable the pooling of resources, ideas and people for the general good of society. Strong institutions facilitate the formation of clubs, joint ventures and partnerships and other such mobilisation of social capital for the promotion of social good. These strong social networks and partnerships established by quality institutions can help unlock the potentials of individuals, and groups and cause them to optimise the benefits from financial inclusion products and services\(^3\).

\(^3\) Read more about the importance of institutions here: [http://www.e-ir.info/2012/09/19/the-importance-of-institutions-to-economic-development/](http://www.e-ir.info/2012/09/19/the-importance-of-institutions-to-economic-development/)
We now turn to the empirical support for the above arguments. Recounting the role of institutions in finance, Qian and Strahan (2007) showed how institutions determine the shape and form of financial contracts. According to the study, in economies with strong protection for creditor rights, loan durations are longer while interest rates are lower. Foreign bank ownership shares are shown to decline as creditor protection decreases. Demetriades and Law (2006) assessed how institutions intermediate the finance growth nexus and produced some interesting findings: first, a strong institutional framework magnifies the growth effect of finance. Second, not much growth dividends inure to poor countries with more finance but weak institutions. Third, the growth magnifying effect of institutions is highest in middle income countries embedded in quality institutions. Fourth, though the effect of finance on growth is lower in high income countries, this impact improves even in these countries when the financial system is rooted in sound institutions. In sum, the study found that finance promotes long run growth in countries endowed with quality institutions. On the contrary, in countries where the financial system is subsumed by weak institutions, improvements in financial systems produce negligible benefits.

In a similar vein, Gazdar and Cherif (2015) demonstrate that while finance variables on their own may sometimes affect growth adversely, institutions turn any negative effect of finance on growth into a positive one. Specifically, banking sector advancement promotes growth in countries with strong law and order, low bureaucracy and good investment pedigree. A dissenting view is offered by Compton and Giedeman (2011) who found banking sector development and institutions to be substitutes in growth while stock markets are neither substitutes nor complements to institutions in growth. Despite the contradictory findings, on the balance of empirical evidence and theoretical plausibility, it will be safe to conclude that institutions play complementary roles to finance in growth.

8. Concluding Remarks

The main aim of this paper was to examine the role of financial inclusion in promoting economic growth. The areas covered include conceptualisation of financial inclusion, trends in financial inclusion, the determinants of and barriers to financial inclusion, link between inclusive finance and financial development, the effect of inclusive finance on economic growth, and the role of institutional architecture in the financial inclusion-economic development nexus. It discussed capital accumulation, innovation and entrepreneurship, income and employment, opportunities for diversification, productivity, and financial security as the main channels through which financial inclusion positively impacts growth.

The paper identified inadequate and lack of supportive infrastructure, high transaction costs, low level of general literacy and financial literacy, high poverty rates, and dispersed population as the factors that limit access to and usage of financial services. Institutions are discussed as being crucial for economic development and improving the growth impact of financial inclusion. This is because institutions reduce transaction costs while increasing efficiency of exchange, determine the rate of return on investment, provide the environment for innovation and creativity, and establish the environment for effective collaboration and mobilisation of social capital.

Going forward, developing countries would be well advised to prioritise financial inclusion in policy decisions and implementation to fully reap its benefits. Financial inclusion should be mainstreamed into social protection programmes so that the poor, the marginalised and the hard to
reach segment of the population will be roped into the formal financial stream. A large informal sector and unbanked population reduces the efficacy of monetary policy, as a greater proportion of the economy will be outside the influence of the policy authorities.

A strong infrastructure backbone is key to the advancement of financial inclusion. Due to the cost involved in setting up infrastructure governmental leadership and support is key in this direction. Governmental infrastructure plans should incorporate financial inclusion. Apart from that, governments should mobilise monetary and non-monetary resources from banks, other financial institutions, telecommunication companies, development partners and other stakeholders in support of the financial inclusion drive. Key infrastructure which must be provided, especially in the hinterlands, to advance financial inclusion include electricity, roads and transport, telecommunications network, water and sanitation, and financial infrastructure such as Credit Reference Bureaus, banks, other financial institutions and regulatory bodies.

Furthermore, digital financial services can be leveraged to reduce the cost of providing financial inclusion to the poor in a safe and convenient manner. Digital financial services such as mobile money services, mobile banking, internet banking, biometric payment systems, ATM banking, financial technology (Fintech) among others must be promoted to ensure convenient, efficient, safe, and cost effective delivery of financial services. For digital financial services to thrive well, a comprehensive and robust regulatory framework, which strikes a fine balance between promotion of financial innovation and amelioration of financial risk and fraud will be imperative. Related to this is the issue of consumer protection, which entails safeguarding users of financial services from Ponzi schemes, fraud and exploitation. Regulatory frameworks, which cover transparent disclosure, fair treatment, dispute resolution and financial education and costs will help foster consumer protection.

The high level of financial illiteracy in the world and in developing countries in particular calls for concern. Mainstreaming financial literacy in educational curricula will be a good step towards creating awareness of financial inclusion and enlightening the population on financial matters. Broad based financial literacy will promote financial planning and prudent financial decision-making at the household level.
References


