Frankfurt School of Finance & Management and Alliance for Financial Inclusion

Developing & Developed Country Perspective on Financial Inclusion: A Global Dialogue

Keynote speech

The importance of financial inclusion in the light of the recent financial crisis

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(*) Speaking in a personal capacity

Ladies and Gentlemen,

It is a real pleasure for me to participate in this global dialogue on financial inclusion and a great honour to be invited to deliver a keynote speech.

Without doubt, financial exclusion remains a global challenge. 2.5 billion people around the globe, including inside the European Union, lack access to formal financial services at reasonable cost. This constitutes a clear call for action. The work of the Alliance for Financial Inclusion, among others, to address this challenge is recommendable.

The issue at stake, promoting the inclusion of people's economic activity into the financial system, has profound consequences.

It goes beyond the narrow financial agenda of allowing for a better spreading of risks within and across countries, which contributes to financial stability.

It goes beyond the broader economic agenda of allowing a wider range of people, especially those on lower incomes, access to financial services, which adds to economic growth.

In fact, financial inclusion is fundamental to the social agenda of reducing income inequality and poverty. In this way, it can be one the levers to achieve higher welfare and lasting peace.

As the Nobel Committee in 2006 noted, when awarding the peace prize to micro-finance pioneer Muhammad Yunus and the Grameen Bank, "*lasting peace cannot be achieved unless large population groups find ways in which to break out of poverty*"[1].

I note in passing that the same Nobel Committee last year awarded its peace prize to the European Union, which underscores the fact that the EU too is

[1] Press release dating 13 October 2006 (http://www.nobelprize.org/nobel_prizes/peace/laureates/2006/press.html) state:

"The Norwegian Nobel Committee has decided to award the Nobel Peace Prize for 2006, divided into two equal parts, to Muhammad Yunus and Grameen Bank for their efforts to create economic and social development from below. Lasting peace can not be achieved unless large population groups find ways in which to break out of poverty. Micro-credit is one such means. Development from below also serves to advance democracy and human rights."[…]

more than just a financial and economic undertaking – it also has profound implications for human development and peace.

Because financial inclusion has these financial, economic and social dimensions, it is clear why central banks take an interest in it – and not just in emerging and developing countries. Yet the core mandates of almost all central banks, even where they have multiple objectives, do not explicitly refer to the promotion of the financial inclusion objective.

The reasons for this are, first, the social policy dimension of financial inclusion brings it more within the remit of governments than central banks; and second, in a market-based economy, financial services are in principle more efficiently provided for by the private sector.

While appropriate public policies are needed to ensure that the private sector does this job properly, it is not up to central banks to create them, even though central banks can play an important supportive role in implementing and overseeing the public policy framework.

That said, this does not mean that central banks cannot play a constructive role in promoting financial inclusion. And this brings me to the main themes of talk today, which are twofold:

First, I would like to illustrate the ways in which the activities of the ECB do in fact contribute to financial inclusion.

Second, I would like to demonstrate how the global financial crisis and the subsequent sovereign debt crisis in the euro area have opened up new aspects of financial inclusion. Specifically, they have created financial *exclusion*.

The ECB's contribution to financial inclusion

Let me begin with the first issue, the ECB's contribution to financial inclusion.

Promoting financial inclusion means taking actions which result in expanding peoples' access to services offered by the formal financial sector. Here, the ECB contributes in three ways.

First, through its own policy actions.

Second, through its contributions to the supportive framework for financial inclusion.

Third, through its contributions to the international activities on financial inclusion.

1) The ECB's own policy actions

The ECB's own policy actions support financial inclusion by promoting trust in the monetary system and the stability of money.

One way the ECB does this is through preserving the *value of money* – maintaining price stability – which has important financial inclusion dimensions.

Price stability protects people receiving fixed incomes, who are often among the most vulnerable in society like pensioners and the unemployed. Moreover, it protects those who lack financial literacy and therefore cannot use financial instrument to protect themselves against inflation.

Indeed, those at the lower end of the income scale implicitly rely more than others on the central bank to defend the purchasing power of their savings.

Another way that the ECB supports trust in the monetary system is through preserving the *safety of money*.

We do this by contributing to the stability of the financial system, and hence the safety of peoples' monetary assets held in banks. Unlike price stability, this is not a specific mandate of the ECB, but we have a duty to contribute to it.

This supports financial inclusion because a safe monetary system is a pre-condition for people to use the financial sector in any form.

By creating, an environment which supports financial inclusion, the ECB makes possible a virtuous circle. The greater the proportion of the economy that have bank accounts and access to credit, and are therefore sensitive to interest rates, the wider the range of actors the ECB can influence through its actions. This in turn enhances the effectiveness of the ECB's monetary policy and financial stability functions, which then supports greater financial inclusion.

Looking forward, the mandate of the ECB will soon be expanding to encompass responsibility for the prudential supervision of banks in all euro area countries, and possibly in other EU member states.

As part of the so-called Single Supervisory Mechanism, the ECB will directly supervise around 130 banking groups, comprising around 85% of euro area banking assets, while the remainder will be supervised at the individual country level operating under common rules. The ECB is expected to take over its supervisory responsibilities in the course of the second half of next year.

These new tasks will add another dimension to the ECB's role in supporting financial inclusion.

We will no longer only be concerned with the stability of the financial *system*, but will also be directly responsible for the stability of *individual financial institutions*. This increases significantly our role in ensuring that the banking system is safe and trustworthy, and thereby, that the pre-conditions exist for access to financial services to be broadened.

2) ECB contributions to the supportive framework for financial inclusion

This leads me to the second leg of the ECB's involvement in financial inclusion – that is, its contributions to the supportive framework for financial inclusion.

The ECB makes a key contribution here by supporting financial market infrastructures, most notably payment systems.

We operate a payment system called TARGET2, which allows banks to transact with one another and settle payments in real time. For many years, prior to the financial crisis, this system was hardly known to the general public. However, now that large imbalances have appeared in the system during the crisis, people are realising how crucial it is to the smooth functioning of the financial system – and therefore to making access to financial services possible.

Beyond this, the ECB also acts as catalyst for integration and innovation in the European retail payments market. Modernisation of retail payment systems and instruments helps lowering costs and hence reduces entry barriers. It is thus also an important element for fostering financial inclusion by drawing in unbanked or under-banked people.

For instance, the ECB has been a strong advocate of the creation of the Single Euro Payments Area (SEPA). This will bring about more price convergence and a broader availability of affordable cashless retail payment instruments in the euro area.

Some of you may wonder how much difference this will make in a developed economic region like the euro area. Indeed, in most euro area countries, account penetration (i.e. the percentage of consumers over the age of 15 having an account at a formal financial institution) is already well above 90%. [2]

However, this is not uniformly the case. Account penetration is close to, or even below, 80% in countries such as Italy, Greece or Portugal. At the level of the EU, around 58 million consumers over the age of 15 do not have a payment account. In other words, there is still some distance that financial infrastructures need to be extended to reach people uniformly across Europe.

The ECB also makes a contribution to financial inclusion in the domain of <u>financial education</u>.

Citizens need a sufficient degree of financial literacy to know how to use the financial system and to be protected from fraudulent activities. The ECB and the Eurosystem – currently 17, probably soon 18, national central banks – hence give a prominent role to financial education activities.

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[2] Information is taken from EU Commission publication dating from May 2013 which quotes data from the Global Findex Database, 2012, World Bank: http://ec.europa.eu/internal_market/finservices-retail/docs/inclusion/20130506-factsheet-3_en.pdf

We have developed various products that aim to educate different target groups on financial issues – mostly children, students and teachers, given their multiplier function. These include online games, such as €CONOMIA[3], cartoons and videos on price stability and competitions for students.[4] We also support the “Child and Youth Finance International Movement”. This global multi-stakeholder network[5] focuses on increasing the financial protection and empowerment of young people across the world.

More generally, we have been consistently promoting financial integration in Europe. Financial integration brings with it widening access to financial markets, expanding financial services and deepening financial transactions conducted at the euro area-wide level. This brings benefits to all those operating in, or wanting to access, the single financial market.

3) Contributions to the international activities on financial inclusion

I now come to the third and final leg of the ECB’s involvement in financial inclusion, which is the international dimension. Here we contribute in multilateral, regional and bilateral settings.

In the multilateral domain, the ECB, as the central bank of the EU, plays a full part in the various G20 fora in which Finance Ministry and Central Bank officials meet. You are no doubt aware that since the Korean Presidency of the G20 in 2010, financial inclusion has become part of the policy agenda of the world’s premier forum for economic cooperation.

A Global Partnership for Financial Inclusion was launched, a Financial Action Plan agreed and a flexible SME Finance Framework set up. In 2012, under Mexican Presidency, it was agreed to work on three areas to foster financial inclusion: peer learning, financial education and financial consumer protection. This year’s Russian Presidency will further advance the agenda as the

[3] €CONOMIA explains how monetary policy works, Inflation Island, that focuses on the effects of inflation, and Top Floor, which explains the tasks of the ECB and the Eurosystem).

[4] Examples are the Generation €uro Students’ Award and “Euro Run” competition

[5] The network comprises a wide range of partners, including financial institutions, governments, multilateral organisations, NGOs and leading academics. The ECB will host the next European Regional Meeting of “Child and Youth Finance International”, in autumn 2013.

Communiqués of the G20 Finance Ministers and Central Bank Governors of 16 February and 19 April have already indicated. Of course, there are also the activities of other bodies such as FATF or the BCBS in which the ECB participates.

In the regional domain, the ECB as an EU institution maintains special relations with candidate and potential candidate countries with an EU accession perspective. Their central banks are close partners, with whom we share our experience in order to prepare them for their future role within the European institutional framework.

In this context, we work with them to strengthen their central banking frameworks, which can help financial inclusion in a number of ways. In particular, it can help reduce the widespread use of foreign currency in their domestic financial system, which often reduces the quality and availability of savings instruments in local currency. This is particularly relevant in this region where euroisation is often widespread.

In the bilateral domain, the ECB undertakes close technical cooperation with central banks outside the EU. For almost 10 years of our 15 years of existence we have conducted cooperation programmes to share experience and build institutional capacity on core central banking topics, in particular monetary policy and financial stability.

This indirectly contributes to financial inclusion through the same channels I outlined above. And in countries where the existing financial system is not well developed, the marginal gains of more effective monetary policy and greater financial stability on financial inclusion are of course greater.

To sum up, by carrying out its policy actions, the ECB provides the foundation on which greater financial inclusion can be built. This foundation is strengthened by our actions in related fields, like payment systems, financial education and financial integration, and by our operations internationally. We play a supportive role in the larger public policy goal which is, to paraphrase Jeremy Bentham, to create the greatest financial access for the greatest number of people.

The financial crisis and financial inclusion

Let me now turn to the second theme of my intervention that I outlined at the beginning: how the financial crisis, and its sequel the euro area sovereign debt crisis, have opened up new aspects of financial inclusion in advanced economies. Specifically, they have created financial *exclusion phenomena* inside the euro area.

One way in which financial exclusion has been visible is via <u>financial disintermediation</u>.

In normal times, banks with liquidity surpluses would lend to banks with liquidity deficits in the interbank market. But for several, interconnected reasons, banks stopped lending to counterparts in stressed countries during the crisis. The central bank – that is the Eurosystem – had to step in and provide banks directly with the needed liquidity.

Needless to say that this type of disintermediation between banks has not supported financial inclusion inside monetary union. It has caused interest rates on loans to vary widely between different countries. And it has meant that, *within* countries, certain classes of borrowers have seen access to credit become very restricted. Those that are most affected have been small- and medium-sized enterprises (SMEs) and households.

To reverse this financial exclusion, the ECB has undertaken a number of so-called unconventional monetary policy measures, starting in October 2008. This is not the time or place to dwell on this, but let me just mention that our measures have included long-term refinancing operations, fixed rate full-allotment provision of liquidity, and additional credit claims as part of an enlarged list of eligible collateral.

Another way in which financial exclusion has been visible is in the process of <u>financial fragmentation</u> in the euro area.

It is of course not uncommon to witness, during periods of high uncertainty and extreme risk aversion, financial transactions in particular markets temporarily coming to a halt. But the euro area has seen a new manifestation of this phenomenon. Depositors in certain countries, rather than reallocating their funds within their domestic financial system, opted instead for exclusion. Many of them moved their deposits into banking systems of countries regarded as less risky. This contributed to the imbalances in the TARGET2 payment system I mentioned earlier.

The ensuing fragmentation of the euro area reinforced the forces of exclusion from credit, notably for SMEs in the countries under strain. This in turn explains why the ECB and other authorities are now paying particular attention to the subject of how to promote bank lending to SMEs – how to “re-include” them, if you will. Indeed, this theme is not so far removed from the financial inclusion topic we see in other fora of promoting access by SMEs to services offered by the financial sector.

A third way in which financial exclusion has been visible in the euro area is through <u>financial disconnect</u>.

By this I mean the situation where certain countries in the euro area – and I do not need to mention names – lost access to financial markets and had to receive public financial support. Their exclusion from market financing, however, had to be matched by a combination of domestic adjustment and greater public financial inclusion, if you like, notably from within the euro area. A European Stability Mechanism was created and IMF/EU financial assistance programmes put in place, in which the ECB has also played various roles, notably helping advise on appropriate financial sector reforms and providing ample liquidity to banks in the countries concerned on the basis of exceptional arrangements as regards the collateral of those countries.

Conclusion

Let me now conclude.

The ECB is currently playing both a conventional and unconventional role when it comes to financial inclusion. But these roles are in fact not so different.

During the crisis, the unconventional role has been prominent, as the ECB has been faced with new types of financial exclusion. It has hence needed extraordinary measures to address the exceptional financial market circumstances prevailing in the euro area. Our actions have been aimed at restoring the expected level of financial inclusion inside a monetary union of advanced economies. Of course, monetary policy alone cannot address the root causes of these financial exclusion phenomena, for which determined and sustained action by governments both at the national and European level is needed.

The same holds for the pursuit of the objective of financial inclusion more generally. Also here, the central bank is creating the supportive environment through which financial inclusion become possible, while other policy makers are more directly responsible and called upon for addressing the financial inclusion agenda head on.

The ECB’s conventional activities help bring more people into the financial system through maintaining price stability and supporting financial stability; through contributing to payment infrastructures, financial education and financial integration; and through taking part in international activities relating to financial inclusion,.

We are fully aware of our responsibilities in this area. And I hope my talk today has reflected that.

Thank you for your attention.