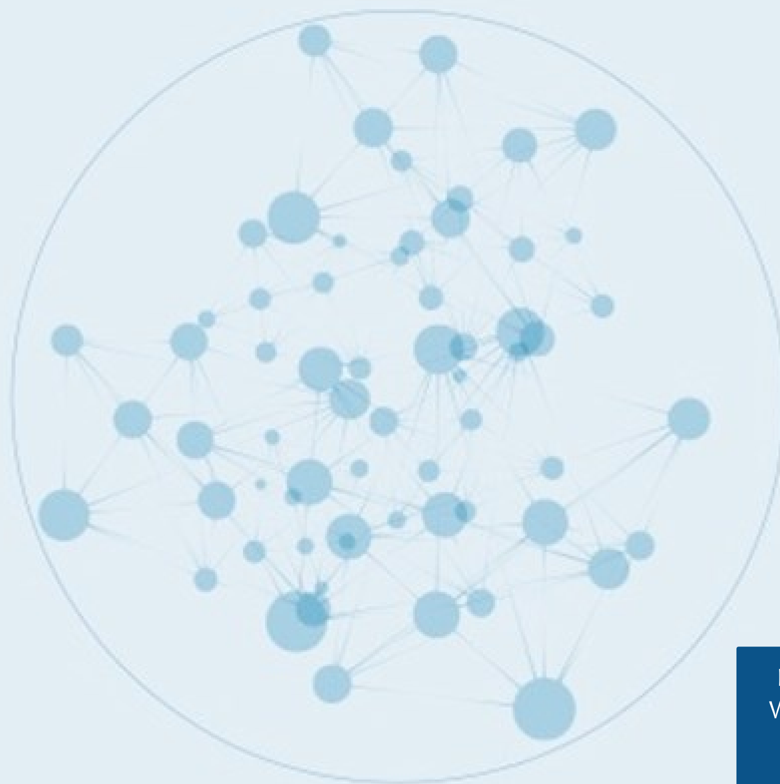
Inquiry: Design of a Sustainable Financial System

UNEP

DESIGN OPTIONS FOR A SUSTAINABLE FINANCIAL SECTOR

Lessons from inclusive banking experiments



INQUIRY WORKING PAPER

15/05

August 2015

The UNEP Inquiry

The Inquiry into the Design of a Sustainable Financial System has been initiated by the United Nations Environment Programme to advance policy options to improve the financial system's effectiveness in mobilizing capital towards a green and inclusive economy—in other words, sustainable development. Established in January 2014, it will publish its final report in October 2015.

More information on the Inquiry is at: *www.unep.org/inquiry* or from: Ms. Mahenau Agha, Director of Outreach *mahenau.agha@unep.org*.

The Centre for International Governance Innovation (CIGI)

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About this report

This working paper results from a workshop the UNEP Inquiry and CIGI held on 2-3 December 2014 in Waterloo, Canada to discuss options for a sustainable global financial system. The workshop included participants from a range of academic and research institutions from the Waterloo region and abroad, including the University of Waterloo, the University of London, Harvard University, and the University of Gothenburg.

Comments are welcome and should be sent to *simon.zadek@unep.org*.

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Abstract

Over 200 years ago, Adam Smith put forward the notion that individuals seeking to benefit themselves through trade were led as if by an invisible hand to a situation in which society as a whole could benefit. It can be argued, however, that social objectives such as sustainability, and inclusiveness, do not emerge spontaneously through market forces. Such outcomes have to be designed through legal structures and institutions. In other words, for the invisible hand to operate, there needs to be a visible hand behind it. The financial inclusion experiment in South Africa provides lessons for the design of the type of financial sector required for the transition from greed to green.

1 Design options for a sustainable financial sector

The notion of an *Inquiry into a sustainable financial sector* (UNEP, 2014) may be construed to suggest that the financial sector can and ought to enable economic sustainability, and that this is in fact is what is expected of a well-functioning financial sector. Such a construct would require a broad overview of the whole system in which the role of the financial sector can be shown to go beyond efficiency (in the sense of the lowest intermediation costs between saver and investor) and look into the actual outcomes achieved through the allocation of real resources. It is precisely the ability of banks and other financial intermediaries to influence the rate of investment that gives the financial sector a key role in society (Keynes, 1971). However, the question here is whether or not investment does, in practice, contribute to the sustainability of the planet. In this paper it is assumed that sustainability goes beyond financial stability, and includes social objectives around the protection, rather than degradation, of the environment.

But how does the financial sector enable sustainability? In particular, is it appropriate for policy and regulation to guide this role, or can we rely on the machinations of the financial sector (through the invisible hand) to deliver what is required? This leads us to ask who (or which convention) determines what is socially acceptable?

Over 200 years ago, Adam Smith put forward the idea that a large number of independent individuals all pursuing private ends were led as if by an invisible hand to a situation in which society as a whole could benefit. The invisible hand metaphor has been used to symbolize the operation of free markets[1] and is often depicted as an ideal, if only government (and big business) could be kept out of things. But underlying this ideal is the supposition that in an environment where everyone minds his own business, the overall order will establish itself spontaneously and can be left to look after itself (Mittermaier, 1987). This *dogmatic free market view* is one that advocates that the market be left to its own devices, with only minimal regulatory interference. To expand the metaphor, the hand behind the invisible hand is (in this view) also an invisible hand.

A more pragmatic approach is one that recognizes that markets operate differently, and have different outcomes, if different laws governing behaviour are in place. Markets can be seen as delicate mechanisms that need to be supported by institutions such as the legal system, and can also be destroyed by them. Seen in this light, we can envisage a visible hand behind the invisible hand. That visible hand, which encompasses the institutional framework established by society and government, provides the environment in which the market functions (Mittermaier, 1987).

This *pragmatic free market approach* argues that the kind of institutions that free markets require in order to operate do not emerge spontaneously through market forces. Such institutions (including legal structures) have to be purposefully created in order to fulfil that function. There must be a visible hand (an appropriate legal and regulatory environment which encompasses social convention) behind the invisible hand in order for markets to operate fairly and allocate efficiently, appropriately and sustainably.

Clearly, the position one takes as a dogmatist or pragmatist determines one's views on the appropriateness of designing interventions for the financial sector with particular allocative outcomes in mind, such as inclusion and sustainability.

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[1] *It is noted that some argue that it was Samuelson in his 1948 textbook, rather than Smith 200 years before, that set out the robust free market and laissez-faire associations of the invisible hand in order to provide support for capitalism during the cold war (see Kennedy, 2012). Others, like Mittermaier (1987) and Viner before him, suggest that Smith's own ideas changed during his lifetime. Nevertheless, it was Smith who coined the phrase and the invisible hand metaphor has taken on a life of its own.*

In its pure form, the dogmatic approach resists any form of regulatory intervention.[2] However, most dogmatic free marketeers appear to accept the need for a central bank to introduce liquidity as and when needed to instil stability (e.g. Benston and Kaufman, 1996). We shall assume then that for a dogmatist, the only tolerable regulatory interventions in the financial sector would be those that ensure stability. In this view, a stable financial sector generates efficient intermediation costs and oils the wheels of commerce. The imposition of any additional objective on the financial sector is not only superfluous – but also unacceptable – as it diverts the financial sector from its appropriate role, which is to allocate resources as the invisible hand leads. The invisible hand allows for a neutral or natural outcome. We will refer to this view of the role of the financial sector as Financial Sector$^{\text{Dogmatic}}$.

For a pragmatic free marketeer, market outcomes are not neutral, but have come about as a consequence of state and social influences that have been institutionalized. As such, the policies and regulations that have led to such outcomes should change in line with social convention or when the outcomes are unacceptable. In this view, it is not only the cost of financial services, but the ability of the financial sector to allocate resources in a socially desirable way that is the benchmark for a well-functioning financial sector (Hawkins, 2004). We shall refer to this concept of the role of the financial sector as Financial Sector$^{\text{Pragmatic}}$ indicating that the outcomes are not neutral but the result of the interaction of policy, regulation and social convention.

From the pragmatic perspective, the belief that the market can always and everywhere be relied upon to produce socially acceptable allocation, is itself a construct of particular policy, regulatory and social convention.[3] While the hand behind the invisible hand may appear invisible, this is merely an illusion. The dogmatic-pragmatic dichotomy provides the backdrop to the analysis – the successes and failures documented below have much to do with the design of the hand behind the invisible hand, and the extent to which this hand is acknowledged.

In the discussion that follows, Section 2 develops the reasons Financial Sector$^{\text{Dogmatic}}$ allows for a role by the central bank but resists the imposition of objectives other than stability for the financial sector. It also considers why this is the dominant view in the sector and under what circumstances Financial Sector$^{\text{Pragmatic}}$ can play a role.

In sections three and four, lessons for the *Inquiry* from financial inclusion experiments in Kenya and South Africa are explored. In particular, the case study of South Africa (after 1994) is presented. A number of initiatives took place in the early 2000s to try to encourage financial inclusion, given that the South African financial sector was characterized as one that served an enclave of the middle class and elite. Initiatives included the establishment of a Financial Sector Charter Council – a body to monitor transformation and inclusion, the development of entry-level financial products and legislation to allow tiered banking. The discussion examines the relative success of these initiatives.

Section five concludes by identifying lessons from the Financial Sector$^{\text{Pragmatic}}$ experiments for the general debate on a sustainable financial sector.

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[2] *Adherents of the free banking approach fall into this category – but this is a minority view. Even Milton Friedman's, monetary rule, it could be argued is a form of intervention.*

[3] *This convention is associated with four assumptions: (a) a given endowment of wealth among individuals; (b) a competitive market (c) administrative efficiency of the market and (d) absence of externalities (Benston and Kaufman, 1996). See further below.*

2 The dominance of Financial Sector$^{\text{Dogmatic}}$

A useful summary of the debate on the appropriate regulation of the financial sector may be found in the May 1996 edition of the *Economic Journal*. Here we see why the dogmatic approach (characterized here as Financial Sector$^{\text{Dogmatic}}$) accepts the necessity of a central bank and a stable financial sector, but rejects any imposition of further social or political objectives.

Benston and Kaufman (1996) state that an unregulated system will produce an optimal allocation of resources, given four assumptions:

- a given endowment of wealth among individuals;
- a competitive market;
- administrative efficiency of the market – that cannot be improved by government interference; and
- absence of externalities.

In their view, despite the fact that there might be violations of the first and the second assumptions in the banking sector, this does not warrant regulation. They appear to provide a weakly positive argument for government provision of deposit insurance (violation of the third assumption), but their argument for regulation rests on the existence of externalities. The positive externalities they identify have to do with money as an accepted medium of exchange and store of value – the more predictable the value of money, the more valuable it is. The negative externalities have to do with contagion related to bank failure. They argue that monetary stability is a prerequisite for bank stability – and the key role for a central bank.

Following Friedman's proposal (1960), we want the central bank to increase some definition of money at a relatively steady rate and certainly prevent declines, and abandon attempts to do more. Not only is prudential regulation unnecessary for monetary control – it is detrimental to it (Benston and Kaufman, 1996). While the debate on which variable (no longer the money supply, but the inflation rate) should be held stable has developed in subsequent years, the acceptance that stability is necessary appears to have endured. For example, in following statement of the South African Reserve Bank (in which stability is mentioned seven times), the promotion of financial stability is tied to the objective of price stability: "The Reserve Bank is required to achieve and maintain price stability in the interest of balanced and sustainable economic growth in South Africa. The achievement of price stability is quantified by the setting of an inflation target by Government that serves as a yardstick against which price stability is measured. The achievement of price stability is underpinned by the stability of the financial system and financial markets. For this reason, the Bank is obliged to actively promote financial stability as one of the important determinants of financial system stability."[4]

The commitment to stability, within the general understanding of Financial Sector$^{\text{Dogmatic}}$ is articulated within the mission of international bodies such as the Banking for International Settlement (BIS): "The mission of the BIS is to serve central banks in their pursuit of monetary and financial stability, to foster international cooperation in those areas and to act as a bank for central banks… Monetary and financial stability is a precondition for sustained economic growth and prosperity."[5]

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[4] https://www.resbank.co.za/AboutUs/Mandate/Pages/Mandate-Home.aspx
[5] *www.bis.org*

The dogmatic free market approach that is associated with the laissez-faire achievement of a profitable and stable sector would prefer to do so without the clumsiness and untidiness of social, political or environmental objectives. Financial Sector^{Dogmatic} has become a philosophical defence to perpetuate the existing institutional constructs that are well-suited to the incumbents of the financial sector.

Shifting the consensus view from a dogmatic to a pragmatic free market view – even for a time – is unlikely to happen unless there is considerable pressure on the financial sector and its regulators. Observation of the South African economy shortly after the introduction of democracy presents such an exception. There was considerable popular pressure and expectation, as well as an influx of new participants – not entirely schooled in the ideology of Financial Sector^{Dogmatic} in positions of relative power and influence. The next section explores the process in more detail.

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