



MAKING FINANCIAL MARKETS WORK FOR THE POOR

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31 October 2004

My thanks to those who commented on drafts of this paper at meetings in Johannesburg and London: Hugh Scott, Mark Napier, Jeremy Leach, Kate Phillip, Anne Marie Chidzero, Sukwinder Arora, Richard Boulter, Karen Ellis, Alan Gibson and Doug Pearce. Errors and omissions remain my responsibility alone.

This paper was commissioned by FinMark Trust, www.finmarktrust.org.za

ABSTRACT

The refrain, “Making Markets Work” (MMW), has been taken up by governments and business schools in recent years. Donor and multilateral organizations have taken it further: markets should work “...for the Poor” (4P). A small but growing literature aims to set out the principles of the MMW4P approach, and to differentiate it from previous approaches to policy.

This paper aims to deepen and extend the MMW4P approach by applying it to a specific sector (financial services) and geography (South Africa), based on the experience of the FinMark Trust programme from 2002 to date. This experience gives rise to certain questions, the answers to which are central to developing the MMW approach. The questions include:

- What does it mean for a market to work for the poor?
- Is increased access to markets always a good thing?
- Is market enablement a sufficient strategy?
- How best to influence market development to become pro-poor?

Case studies from SA financial sector in the past ten years are used to provide answers to these questions.

Key words: Making Markets Work, MMW, Financial sector development, Private sector development, transaction banking, MMW4P

EXECUTIVE SUMMARY

1. 'Making Markets Work' (MMW) has become a mantra of policy makers, donors and educators. The Making Markets Work for the poor approach (MMW4P) goes beyond standard notions of promoting market efficiency to harness the power of markets to provide goods and services to poor people on a sustainable basis.
2. This paper seeks to extend the conceptual framework of the emerging Making Markets Work for the Poor approach through applying it to the particular circumstances and experience of financial markets in South Africa, mainly through the experiences of FinMark Trust.
3. The ultimate objective of MMW4P is the expansion of real choices offered to poor people by markets. Necessary indicators of this are:
 - usage by poor people of a service or product is increasing;
 - poor people have alternatives; and
 - a market in the service in question is considered acceptable.These conditions can and should be measured and monitored over time.
4. The access frontier is the maximum proportion of usage possible under existing structural conditions (of technology, infrastructure and regulation). This frontier is likely to shift over time.
5. Financial markets have inherently high transaction costs and are particularly fragile, hence are vulnerable to changes in institutional arrangements and prone to market failure. This fragility warrants some, but not too much, caution in changing policies.
6. There are four basic categories of retail financial services, which are inter-related: transaction banking, credit, savings and insurance. Transaction banking is receiving increasing focus as the key to unlock greater access to the others.
7. There is increasing evidence that financial sector development (FSD) causes growth and poverty reduction, hence there is a strong argument for active promotion of FSD.
8. Studies in various countries have shown that poor people use a number of financial instruments—formal and informal, market and non-market—depending on their needs and access. Formal products often complement rather than substitute for informal products.
9. Applying the conceptual tools developed in this paper to transaction bank accounts in the US suggests that the market there is close to its natural limit; while in SA, it is merely approaching the current access frontier at around the 50% usage level.
10. Policy to promote pro-poor financial sector development must start with an analysis of the current level and trajectory of usage in a market, together with an assessment of where the current access frontier is, and where it may move in the short to medium term.
11. In the area which the market is unlikely to touch in the foreseeable future ('the supra-market zone'), the state often supplies the service directly or regulates existing institutions to provide it (i.e. forced cross subsidy). Other newer approaches are emerging, such as industry access funds. The MMW4P test of all such policies is whether they encourage the outward movement of the access frontier so that more can be served through markets over time.
12. The recently launched basic bank account in South Africa is assessed as an illustration of the conceptual framework. There is an argument for co-operative solutions to market provision but the nature of the cooperation must be carefully defined.

Listing of case studies:

1. Is increased usage always a good thing? Microcredit in SA 1993-2004
2. Are there limits to markets? The cell phone industry in SA 1993-2004
3. Is market enablement sufficient? Housing finance in SA 1994- 2004
4. What is the role of a market catalyst? FinMark Trust 2002- 2004

A glossary of acronyms and terms may be found at the end of the paper.

1. INTRODUCTION

“It is not self evident that private markets will reduce poverty; indeed, they may exacerbate it. Even where economic growth raises all incomes over time as private markets expand, the time period may be very lengthy indeed and the distribution of benefits may be very uneven. An important goal of state regulation of markets, therefore, may be poverty reduction.” Cook et al (2003:11).

“Making Markets Work” (MMW) has become a mantra of the present age. It has been taken up by leading multilateral bodies like the World Bank and international donor agencies such as DFID and SIDA as a way of redefining their private sector development strategies¹. Policy makers and regulators also speak explicitly of making markets work better². Harvard Business School has recently developed an Executive Education course entitled “Making Markets Work”, aimed at public and private sector leaders in developing countries.

Interest in MMW has risen as the result of several underlying trends. First, the allocative efficiency over time of market-based economic systems was conclusively demonstrated in the collapse of socialism in late 1980s. However, this has led to more intense discussion about the appropriate role of the state in the delivery of services and, especially, in poverty alleviation. It is not self-evident that markets alone will do this, as the quotation above suggests. South African President Mbeki has declared recently: “one cannot rely on the market” to solve poverty and underdevelopment³. The so-called ‘developmental state’ envisaged by the President plays an active role in the political economy, from the expansion of direct state-led anti-poverty programmes, such as public works and social grants; to a reconfigured role for state-owned enterprises in providing the infrastructure for economic growth. However, the 21st century developmental state cannot reject the role of markets; and must therefore face squarely the question of how to channel their economic power in pursuit of development objectives.

Second, increasing globalization has constrained the power of states, especially developing countries, to intervene in markets; while the power of firms and of markets themselves has grown as they have expanded and integrated across national boundaries. This has generated fears in some quarters that markets have become too powerful.

Whether out of fear or pragmatism, therefore, policy makers have shown growing desire to harness the energy of these ascendant markets and make them work in the service of a particular societal goal.

Neither trend is new, although the rising disillusionment with old recipes of market friendly reforms has added impetus to the recent search for new approaches. In contrast, the inherent belief that markets generally work in the broader national interest goes back a long way. Adam Smith gave early and powerful assurance that, left to themselves, markets provide an amazingly

¹ See SIDA (2003), DFID (2000 and 2004)

² As one recent example, the new credit policy in SA is entitled, “Making Credit Markets Work”

³ Quoted in *Financial Mail*, 2 July 2004 p.20

efficient self-regulating mechanism for economic life. However, for all the reliance placed on market mechanisms and all the academic interest in market-based economics, the level of understanding and analysis of the role of markets themselves lags far behind. With the exception of the all too visible capital and foreign exchange markets (which are in fact largely electronic and therefore invisible!), markets often remain shadowy institutions lurking in the background of analysis and discourse—opaque to many. In 1996, shortly after his appointment, South African Finance Minister Trevor Manuel famously described financial markets as ‘amorphous’. He was promptly punished for his lack of faith in the substance of markets by their sharp fall.⁴

The MMW for the poor (MMW4P) approach focuses explicitly on the workings of markets; and seeks to judge them and influence them in relation to their impact on the poor. The approach has been promoted by donors such as SIDA and DFID, based on their experiences of private sector development. A recent paper by Gibson, Scott and Ferrand (2004) provides the best overall framework of the approach to date, on which this paper will seek to build. MMW4P is also closely associated with the search for ways in which business, as a key participant in most markets, can contribute to poverty reduction. This search has been spearheaded by the UNDP, following the UN Millennium Development Goals; and the opportunities for business in low income markets have been promoted by leading management theorists such as Prahalad (2004). Annexure A traces the roots of the MMW4P approach and summarizes recent concept papers on the subject for the reader who is unfamiliar with it.

MMW4P is a new, evolving approach but it is vulnerable to accusations that it is simply repackaging an old approach with a new face. It is also vulnerable to accusations that it is too conceptual, hence hard to implement; and too anecdotal, hence of limited application anyway. To move the MMW4P approach beyond being considered conceptual or anecdotal, some questions must be answered. These include: given the incredible diversity of market types and stages of development, what are the necessary or sufficient conditions for a market to function well for the poor? And how does one assess developments in a certain market over time to be pro-poor? Markets are so pervasive and so diverse that to begin to answer these questions, it is necessary to ‘zoom in’ to a finer level of detail, at which it is possible to isolate some of the working elements of an answer. This is the main *raison d’être* for this paper.

This paper applies the emerging MMW4P approach to one sector—the financial sector; using case study examples from one country—South Africa. It so happens that the financial sector has special features which make it a fruitful sector to which to apply MMW. And South Africa has a financial sector which combines developed and developing country features in an interesting way, creating a rich vein of analysis to mine. Nonetheless, the ‘zooming out’ from the specific case back to the general must be done with care.

The paper is not intended to be an exhaustive history of FinMark Trust, the DFID-funded programme in South Africa, which has sought to put this approach into practice from 2002 to the present. However, the work to date in the richly challenging environment of the South African financial sector has yielded raw insights, which may be useful for the broader MMW agenda. This paper refines the raw insights into a more usable form.

⁴ Stock and foreign exchange markets fell due to investor fears that the new, unknown Minister would not trust market mechanisms and would intervene. These fears proved unfounded; but the Minister stopped musing in public.

Specifically, it seeks to use concrete examples from SA as case studies to suggest answers to the following defining questions:

1. What does it mean for markets to work for the poor? (How to define and measure it?)
2. Is increased access to markets always a good thing?
3. Is market enablement a sufficient strategy for poverty reduction?
4. How best to influence market development to become pro-poor over time?

The case studies follow in the annexures to the paper, with summaries in the body. The next section of the paper develops conceptual tools with which to understand and assess market development over time. Section 3 applies the approach to the financial sector in general, and the specific tools to a particular category of retail financial services, namely transaction banking. The focus on retail financial markets, rather than wholesale markets, is deliberate: not because the latter do not matter, but because the former touch more directly on the lives of poor people in ways that will be discussed. While transaction banking is only one of four major categories of financial service to be discussed, it is increasingly recognized as the key to the other categories and furthermore, there are useful emerging comparative data sets in this area. Coverage of MMW in the other important categories will have to await a bigger project than the current paper.

The final section before the Conclusion develops the implications for policy makers and donors interested in pro-poor market development.

2. MARKET PERFORMANCE: THE WELL FUNCTIONING MARKET AND THE POOR

“The market mechanism which arouses passion in favour as well as against, is a basic arrangement through which people can interact with each other and undertake mutually advantageous activities. In this light, it is very hard to see how any reasonable critic could be against the market mechanism as such. The problems that arise, spring typically from other sources and include such concerns as the adequate preparedness to make use of market transactions, unconstrained concealment of information of unregulated use of activities that allow the powerful to capitalize on their asymmetrical advantage. These have to be dealt with not by suppressing markets, but by allowing them to function better and with greater fairness, and with adequate supplementation. The overall achievements of markets are deeply contingent on political and social arrangements” Amartya Sen (1999:142).

Section 2 Summary

- The ultimate objective of MMW4P is that the real choices of poor people should be expanding.
- Necessary conditions for this are:
 - usage by poor people of a service or product is increasing;
 - poor people have alternatives; and
 - a market in the service in question is considered acceptable.
- These conditions can all be monitored over time.
- The access frontier is the maximum proportion of usage possible under existing structural conditions (of technology, infrastructure and regulation).

2.1 What does it mean for a market to work and to work for the poor?

Before a market can work for the poor, it must first work at all. Markets are institutions, which work by efficiently facilitating exchange. A well functioning market reduces transaction cost between buyers and sellers to a minimum.

A working market has three components, in addition to consumers:

- An *institutional foundation*, which comprises the laws, rules, regulations and, indeed, regulatory enforcement capacity to establish and sustain the market;
- *Organizations* which provide services in the market: although the market structure—in terms of number, size and type of organization—will vary greatly among market sectors, based inter alia on their history, their stage of growth and the barriers to entry in the sector;
- *Support organizations* that provide intermediate services to market players and regulators: these range from the basic required services (audit, legal, IT) to market research and intelligence.

In a well functioning market, while each component will differ in form, there will be certainty and basic stability about how the components fit together. In newer markets, the roles of the different players are often still in process of definition. An inherent characteristic of free markets, which will be taken up in the next section, is their constant evolution in response to changing circumstances and feedback effects from other markets.

This categorization of components focuses on the supply side but, of course, markets need consumers too. Poor people may or may not be among the consumer base of a particular market; and, even if they are, a particular market may only partially meet their needs. The core assertion of the MMW4P approach is that markets can and should work *for the poor*. The addition of this distributional criterion requires more of markets than that they simply work. Typically, distributional considerations have been seen as outside the market. States, not markets, have the power to re-distribute income. This power influences who can participate in markets—after all, financial markets work in the currency of money and, without it, no buyer may participate. But what does it mean for a market to work for the poor (an issue of definition)? And how can we know that a particular market is working for the poor (an issue of measurement)?

The quotation at the beginning of this section from Amartya Sen's seminal work, *Development as Freedom*, highlights that markets facilitate voluntary exchange between people and that this is *per se* unobjectionable. For Sen, true development involves expanding the real choices of poor people; their greater freedom to choose is in itself the goal of development. Therefore, a market that works for the poor is one which expands the choices available to poor people.

Sen argues that increasing freedom to choose is sufficient for development. However, the ability to choose is hard to measure in practice: choice is constrained by various factors—such as information set, income, geography, even culture. To make this objective useful in assessing approaches to pro-poor market development, it is necessary to seek robust indicators of expanding choice.

In the most recent conceptual paper on MMW4P, Gibson, Scott & Ferrand propose that, “while markets work in a variety of ways, ultimately they benefit the poor by being accessible and appropriate” (2004:7). In other words, accessibility and appropriateness to the poor are necessary conditions for a market to work for the poor. Neither concept is easy to measure.

It is easier to agree on what it is inappropriate (say, trade in narcotics or even in body parts which occur in some poorer communities and indeed can be important sources of income) than what is appropriate. For example, a decade ago, many thought that cell phone communication was inappropriate for poor people—it required numeracy and was relatively expensive. A decade later, most people believe otherwise, as poor people by the million have purchased cell phones (see Case Study 2). Likewise, debates still rage over the ‘appropriateness’ of consumer credit for the poor; but these debates often take place in the abstract with no knowledge of the alternatives or circumstances in which the choices to use such credit are being made. Appropriateness is too demanding a concept, therefore, to be applied in practice. A ‘stripped down’, more usable necessary pre-condition for a market that works for the poor, is simply that where society deems that a market in a service or product is not desirable, such a market cannot work for the poor.

As with appropriateness, accessibility can be a slippery concept. It must be distinguished from usage; and to be applied, it must be narrowed to 'effective access' by adding various qualifications. Annexure B documents the recent evolution of thinking about definitions and measurement of effective access to markets, driven in part by the explicit introduction of access targets in the SA Financial Services Charter in 2003. As a result, access has become better defined but is still hard to measure in practice.

Even if it can be measured, access may not be the right indicator. One can easily envision a market where a good or service is accessible by some definition, but poor people may still choose not to use it. This surely cannot be a market 'working for the poor'—they simply aren't participating in it! Perhaps the definition of effective access or the appropriateness of the service in question is defective. But this is the point: it is hard to know, even *ex post*, if this is so.

In contrast to access, usage by poor people of a good or service is a more robust measure. In other words, a market which works for the poor is one in which usage of the product by poor people is increasing over time. Increasing usage clearly implies both accessibility and appropriateness, without the need to define either too closely. Rather the market is judged by its fruits—who is using it?—on an ongoing basis. The usage profile can be measured relatively easily through statistical sampling of market participants or, indeed, analysing customer databases if customer income and other characteristics are available.

The easier something is to measure, the more likely it will be tracked over time. This is important since the trajectory of usage—is it upwards?—may be more important than the absolute level, which may be low. In particular, the proportion of poor customers (by whatever local or global definition) to total customers in a particular market segment could be tracked over time. If the proportion is growing, then relatively more poor people are using the products provided by that market. Other standardized indicators may be derived from usage numbers to compare the extent to which different markets are working for the poor: for example, the percentage change in the proportion of poor customers per unit of time (year); or alternatively, the time taken for the proportion of poor customers to increase by 1%.⁵ State statistical agencies could collect the data in market segments, which particularly affect the welfare of poor consumers.

Individual firms supplying these markets may be distinguished for acclamation or reward, based on the extent to which their own usage measure exceeds the sectoral average. The best practice companies in Prahalad's (2004) case studies would presumably all qualify; indeed, applying the measure to them would be a useful test both of its robustness as well as the extent to which poor customers were significant in their overall business models (as opposed to just a flagship project).

However, while usage may be superior to access in practice, as an indicator of working for the poor, usage alone is not a sufficient criterion. Usage by the poor could reflect the lack of any alternative; in other words, a grudge purchase. Therefore it is necessary to add the further

⁵ In the spirit of the physical measure of the amount of work necessary to displace a force of 1N through 1m being the Joule, the standard measure of the work being done by markets may perhaps be named the *ecoJoule!*

necessary condition that, as usage increases, there must be alternative products available within a market; or functional substitutes in other markets. The presence of alternatives is easier to observe than choice, since it does not require the choice set in a person's mind to be understood but rather simply the presence of competitive products within a particular market place. With this condition, usage patterns do reveal preference accurately.

More fundamentally, even in areas where markets are permitted, is greater usage always a good thing? Case Study 1 addresses this question, using the example of micro-credit in South Africa from 1993, when usage expanded dramatically but with unforeseen consequences. The case suggests that, while greater usage is usually a good thing for the poor, there are circumstances where it is not; such as where excessive growth can have negative consequences for a market and other interlinked markets. In such cases, usually characterized by rapid growth, regulators and market players alike should exercise caution.

Summary of Case Study 1: Micro Finance in South Africa 1993-2004

Commercial microfinance in South Africa began with the removal of interest rate ceilings on small loans in late 1992. With no barriers to entry and hardly any functional regulation as well as substantial repressed demand, the market burgeoned in the mid-Nineties. Rapid growth brought mounting fears of widespread abusive practices by lenders; and of a consumer credit bubble among certain mid- to low level salary earners in particular. The growth came as a result of particular lending technologies, which encouraged lenders not to perform standard credit assessments and, in many cases, to lend blindly.

The state introduced a new micro-credit regulator in 1999 and outlawed certain lending practices; and, in 2000, suddenly revoked for its employees one of the payment technologies on which micro-lending had relied. This action in particular destabilized the sector and led directly and indirectly to a full blown banking crisis in 2002 in which two banks engaged in micro-lending collapsed. This unintended consequence led to high costs for the state, as well as shareholders and depositors in failed institutions.

The case is used to discuss whether greater access, as was witnessed, is always a good thing. The argument is made that, while greater access for consumers is in general better, a sound framework is required to ensure sustainable growth; and the implications, for other markets, of growth in one market must also be considered.

The presence of two necessary conditions is enough to show the market is working for the poor:

1. that usage by poor people is increasing over time; and
2. that there are alternatives available.

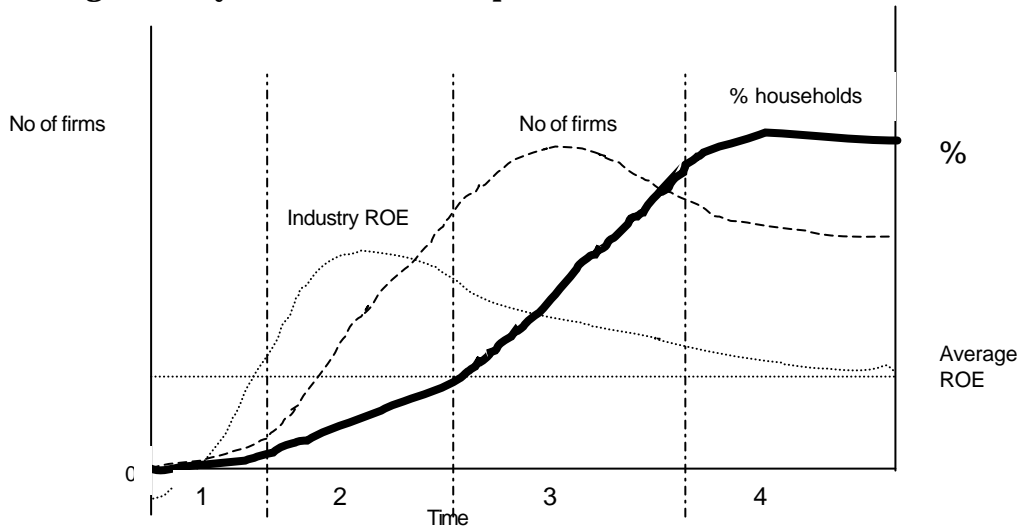
With a definition and measurement device in hand, we can now proceed to the question of how markets promote greater usage over time.

2.2 Market development over time

Although individual markets may differ substantially, it is possible to posit certain stylized facts of general market development. Figure 1 below summarizes the conventional 'stages of market

growth' model, tracking the number of firms in a given market segment (market structure), the average firm profitability and the percentage of eligible consumers using the product (market size).

Figure 1: Stylized Market development over time



The Figure above tells the following story of market development. In the *first phase*, one firm or a few pioneering suppliers bring an early product to market. They often make losses due to heavy R&D investment, which they hope to recoup at a later stage (hence the average ROE line is below zero); and they serve a small number of early adopter-type customers.

However, the experimentation results in a product which works: this is shown by increasing numbers of clients in *Phase 2*; and the consequent move to profitability by the initial firms. This success prompts other firms to enter the market. Competition may initially be on the basis of service quality or by product differentiation.

By *Phase 3*, competition is usually on price terms as the product features start to become commoditized. As supply continues to increase and firms compete more, prices start to fall. This creates a virtuous cycle of boosting further demand, hence usage grows rapidly in this phase as the market broadens. It is quite likely that the supply will overshoot—a number of suppliers will not be able to survive, and will withdraw from the market as it consolidates in *Phase 4*. Remaining firms benefit from greater economies of scale as market acceptance and usage grows further, but prices fall further, pushing the average profitability of this market sector back towards the overall risk adjusted average. The overall level of usage of the product reaches saturation at some natural limit, at which point all who wish to use the product and service are able to. Hence, non-usage is then a function of genuine, not income-constrained, choice.

After reaching the natural limit, turnover in the market consists mainly of replacement sales and any growth in volume is generated by exogenous factors such as demographics—an increase in

the number of households for example. Demography has driven growth in the US economy in recent years, even in apparently saturated markets.

This stylized trajectory has been demonstrated over the long run in a number of industry sectors in developed markets, such as cars and telecoms. The usage in both has flattened out at a level where high proportions of eligible people in the society are using the product, while the number of firms supplying and the profitability of these firms has stabilized.

For example, at the turn of the 20th Century, very few American households had a car; by 1950, 59% of households had one or more cars, and this had grown to 82% by 1970⁶. Since then, the proportion owning cars has risen further, and is generally considered to be at saturation point. The growth in usage was caused by continuous technological improvements, which reduced the cost of car manufacture relative to consumer incomes, in a competitive, increasingly global marketplace. It has also been supported by the development of other linked markets: for example, in 1950, over half of all new US passenger cars were bought for cash; but the development of instalment credit markets, backed by car makers, reduced this to a third by 1970. This made the purchase of a car less 'lumpy' in cash flow terms upfront. Also, the development of second hand car markets, a corollary of the growth of new car markets, offered a more affordable entry to car ownership. These second hand markets (such as yard sales and eBay, discussed in Annex A) work only for durable goods however.

Telephony is not durable; it is a service with high fixed cost, low marginal cost and strong network externalities. In 1920, the first year for which such data is available, 35% of US households had a phone. Fifty years later, this had risen to 90.5%, surely close to saturation.⁷ Over a similar period, the average cost of a daytime call from New York City to selected other major cities had fallen from around \$8 for three minutes to \$1, a reduction of 88%. Phone service in the US over the period was a monopoly private industry, heavily regulated by the government for objectives that included reaching access targets.

A more recent and relevant example, is that of cell phones, which have spread rapidly in developing countries including SA, and which are overwhelmingly market-supplied. The cell phone industry in SA provides a context in which to ask about the natural limits to markets, addressed in Case Study 2.

Summary of Case Study 2: The Cell Phone Industry in South Africa 1993-2004

This case considers the widespread growth of cell phone usage in South Africa, from a zero base in 1993 to over 10 million users in 2003. These usage levels are well in excess of original projections and continue to grow, especially among poorer segments of the SA population. The cell phone industry has been almost entirely market driven, with low levels of state access regulation, and yet a successful access outcome. This is contrasted with the costly and largely unsuccessful fixed line roll out to poorer households of the main state owned operator, Telkom. Cell phones appear to be a market that is working for the poor in terms of the definition suggested.

⁶ Data from *Statistical History of the US Datapedia* Series Q163-174

⁷ Data from *Statistical History of the US Datapedia* Series R1-12

The case study discusses features of the cell market that have enabled this, including: repackaging the product (to allow for pre-payment); price discrimination among users, reduced entry cost or 'lumpiness' and competition among providers. Even at current levels of usage, most providers believe that the SA market has potential for further growth to as many as 24 million customers (almost 60% of total population). As long as the revenue from usage exceeds the (low but fixed) marginal costs of a connection and of the sign up of an additional service, there remains an incentive to expand the customer base.

Is the stylized trajectory, shown in the cell phone case, of increasing usage towards an eventual natural limit, inevitable?

Markets clearly have in-built 'growth hormones' during the early phases of growth. As long as demand is price elastic, the pursuit of further profit by incumbent and entrant firms will drive price reduction over time, which in turn grows the potential market size. Growth in itself may generate virtuous cycles—for example, through economies of scale, which enable further cost reduction and/or profitability to be achieved. In the presence of competitive forces that allow new entry, it is reasonable to expect that a healthy market will show this increasing usage—but at a decreasing rate as it approaches a natural limit.

However, markets are also constrained by the overall level of income in a society, which is the result of interaction with other markets, such as the labour market. In a society with declining income levels, the 'growth hormones' of most markets will be overcome by the greater downward drag. In the next sub-section, the question of how to control for the level of income in market development is addressed directly.

It is also important to note that the usage trajectory does not assume that goods are always launched at the high end of a market, and that usage then spreads downwards over time. The opposite may happen, and still result in increasing usage. However, the norm appears to be that low end disruptive innovations displace demand for products which have first been developed for the higher end of the market, as Christensen & Raynor (2003) have documented.

2.3 Access frontiers and natural limits

In developed societies with higher levels of income, it is possible to speak of real saturation at the natural limit. Markets cannot be expected to work for consumers without income; hence the conceptual problem in developing societies is how to separate out income constraints on usage from other constraints. This is critical to making policy choices that harness markets for the poor, as opposed to saddling them with unbearable burdens.

To achieve this distinction, the concept of the access frontier must be introduced. The access frontier defines the current maximum proportion of people in a society who could access a product or service, given the current configuration of costs and market structure. The access frontier is clearly affected by regulatory as well as technological considerations, which will influence what is supplied, at what price, to which consumers in a market.

Current levels of usage may be below the access frontier, as shown in Figure 2 below, where U_n is below U_{a1} , which is the current access frontier. Clearly, the frontier could and should change

over time: indeed, in a healthy market, it will be pushed outwards over time; bringing a further group of consumers into the market— U_{a1} to U_{a2} in Figure 2 below. However, establishing where this boundary is enables the first clear diagnosis of whether the market is above or at its access frontier.

Once this is clear, the next order policy question is how to ensure that the frontier continues to shift outwards over time: in other words, that the reach of those served by market provided solutions is growing.

Figure 2: Market development and the access frontier

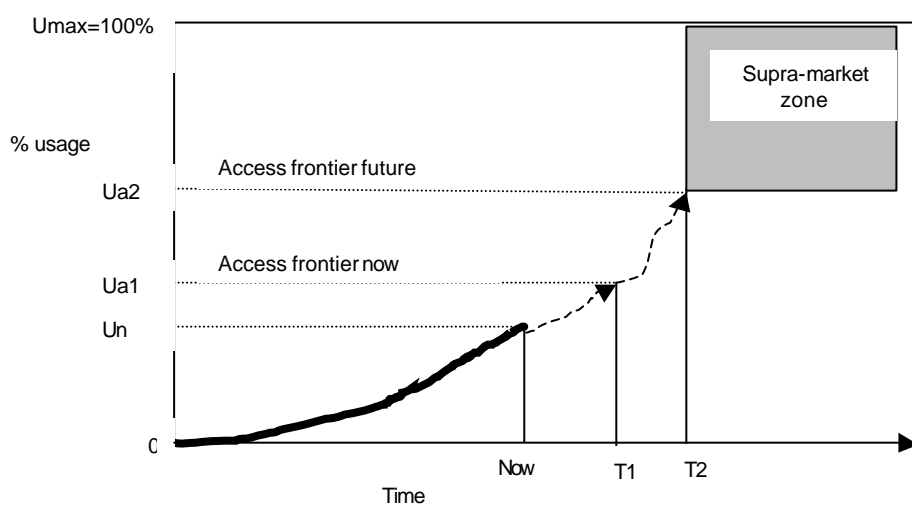


Figure 2 also shows the shaded 'supra-market zone' which is comprised of consumers beyond the reach of the direct market in the foreseeable future due to lack of income (i.e. those between U_{max} and U_{a2} who will not be within the expected frontier at $T2$). These represent in most cases the very poor with very low or no cash income.

If the state desires to accelerate usage of a particular service beyond the trajectory of the access frontier into the supra-market zone, it can do so through various redistributive techniques, such as:

- provide the service itself (essentially an indirect transfer from the fiscus if the service is not fully priced)
- pay others to provide the service (a direct transfer)
- transfer to consumers the specific means to buy the service, such as through vouchers (a direct transfer) or
- require existing providers to cross subsidize the extension of the service (use of regulatory power, where the costs are born by existing consumers and shareholders).

There have long been debates about the relative efficiency of the various techniques above. Often, multiple strategies are used with some inconsistencies among them. However, the insight that MMW4P brings to the debate, on strategies to serve the very poor, is this: the test of state

intervention in this supra-market zone is what effect it has on the present and future movement of the access frontier. If the action of the state effectively crowds out private provision for all time, then the access frontier becomes a ceiling; and that market cannot work further for the poor. The state has effectively locked itself into the long-term fiscal burden of provision. But, if the state intervention can meet the needs of the very poor, while maintaining the incentive for private firms to push the access frontier, then the state is designing its own exit strategy and limiting its fiscal liability.

Several market-specific features will determine the current level of the access frontier—whether high (i.e. more inclusive of the poor) or low (i.e. more exclusive). These include standard considerations such as the level of competition, although the application of competition policy in different sectors is often by no means standard. However, in terms of working for the poor specifically, three features are of particular interest.

First, the ability of suppliers to **price discriminate** within the market, charging more to those prepared to pay more and vice versa, since this enables market-determined cross-subsidization to take place in sustainable fashion. The ability will be determined by regulatory factors (for example, interest rate caps limit the ability to do this in credit markets), and the characteristics of the product (whether these allow for re-packaging in different ways to different markets). Voluntary price discrimination by suppliers as a strategy of profit maximization is different from cross-subsidization mandated by government: the latter usually only spreads costs, while the former may unlock profitable new market niches under the discipline of competitors with different market strategies.

Second, the **lumpiness of the product** i.e. how much must be laid out upfront to purchase the product relative to income. This is determined by the size and value of the good itself. Even if lumpy, there are ways to reduce lumpiness by spreading the cost over time: this is an important enabling feature of financial services for the poor, as Stuart Rutherford has pointed out. For example, the ability to access consumer finance reduces the upfront cost of a car (or house) to a small deposit or initial payment. Without instalment finance, the penetration of car ownership would be much lower; indeed, the growth of the proportion of cars sold on credit in the latter half of the 20th Century was an important part of total growth, as noted earlier. Financing to reduce lumpiness even applies to cell phones, which are penetrating far deeper in developing countries than car ownership.

Third, the **scale** of possible production and distribution in the market. This will determine whether economies of scale are achievable or not. Lower prices per unit, in poorer markets, require larger volumes to generate profitability levels that justify the level of capital expenditure and risk assumed by private capital. This may affect the level of market concentration, especially in small markets, therefore market conduct and barriers to entry issues require careful consideration.

In addition, the presence of strong network externalities may complicate the scale equation in certain markets such as telephony and transaction banking, which is a focus in this paper. Positive externalities mean that value to the Nth consumer is in part determined by how big 'N' is. The network value is typically large at large numbers; and small at small numbers. This

means that a market may go through a dramatic acceleration in certain ranges, or may stall at a lower level equilibrium.

The network effect contributes to the existence of the 'I' curve of product adoption, observed in some developing countries, steeper than the textbook 'S' curve. Prahalad notes the existence of the I curve as a positive incentive for entrants to developing markets who may see rapid market growth. However, equally, the steepness of the slope may deter entry, since large upfront investments are required to benefit from the 'up-draught'. Cell phone networks are good examples. But they also illustrate the point that large fixed investments are required, and the stability of a country and its regulatory system will affect the willingness to invest in advance of the usage trajectory.

In order to reach specific policy conclusions about pro-poor market development, this section has therefore argued that it is necessary to:

- establish the current level of usage by the poor and the trajectory over time;
- establish the current access frontier, and its trajectory over time; and
- assess the redistributive policies in the light of how they affect the movement of the frontier.

The next section focuses on financial markets specifically, and to illustrate the approach to MMW4P developed here, it uses the market for transaction bank accounts in SA.

3. FINANCIAL MARKETS AND THE POOR

Section 3 Summary

- Financial markets have inherently high transaction costs and are particularly fragile, hence are particularly affected by institutional arrangements and prone to market failure.
- There are four basic categories of retail financial services that are inter-related: transaction banking, credit, savings and insurance. Transaction banking is receiving increasing focus as the key to greater access to the others.
- There is increasing evidence that financial sector development causes growth and poverty reduction, therefore a strong argument for active promotion of FSD.
- Studies in various countries have shown that poor people use a number of financial instruments—formal and informal, market and non-market—depending on their needs and access. Usage is often complementary rather than substitutionary across these categories.
- Applying the tools of the preceding section to the market for transaction bank accounts in the US suggests that the market is close to its natural limit; while in SA, it is merely approaching the current access frontier at around the 50% usage level.

3.1 Special characteristics of financial markets

The various financial markets have particular characteristics, which shape, and are shaped by, the transaction costs paid by both consumers as buyers and financial service providers as sellers. Transaction costs are hard to measure in practice. In the absence of accurate empirical data, it can only be asserted that transaction costs in financial markets are higher, and therefore even more significant, than in most other markets. This assertion is based on the relatively high informational requirement in financial services, both *ex ante* and *ex post*, which results in the higher costs of searching, collecting and processing information. In addition, financial service markets have several other distinct features that increase transaction costs.

First, financial service transactions are often subject to externalities; that is, the price paid for the transaction does not reflect its full social cost or benefit.

One type of externality, described earlier, comes from the networked nature of modern financial services. The network may have positive and negative effects on individual network members. On the one hand, network effects increase the value to an individual consumer of being part of the network, such as having a bank account, as the total number with bank accounts rises. This is because cheaper, safer electronic person-to-person fund transfers are easier. These positive effects only manifest at a critical mass of consumers. On the negative side, the interlinked nature of the banking system means that a crisis of confidence in one bank can rapidly develop into a systemic banking crisis. For this reason, deposit insurance schemes, which typically protect smaller depositors against loss, may be understood not only as insurance mechanisms but as a

means of reducing transaction costs for the depositor: in the absence of such cover, each depositor would need to research the health of a bank upfront, and then monitor it over time. The presence of these network effects means that financial markets may be more prone to failure than markets less affected by contagion.

Second, as a result of its fragility, the financial sector tends to be the most heavily prudentially and functionally regulated sector in most economies. For example, concerns over the informational asymmetries between vulnerable consumers and financial providers also lead to onerous consumer protection laws, such as detailed disclosure requirements on each transaction. These requirements may change the level and distribution of transaction costs: perhaps reducing search costs for consumers, due to the standardization of disclosure, but transferring them to the provider.

Transaction costs do not explain all market-related phenomena, however. Johnson (2001) has applied institutional analysis to understanding the fragmentation of financial markets in the town of Karatina, Kenya. She finds evidence that the local financial services market is driven not by transaction costs alone, which would lead to logical market segmentation (i.e. when the adjusted all-in-cost to the consumer is the same). Rather, the extent of fragmentation of Karatina's financial markets into various institutional forms—including banks, micro finance intermediaries (MFIs), co-ops and accumulating savings and credit associations (ASCAs)—can be explained only by underlying social structures. These require different solutions to the collective action problem of how to intermediate savings into loans, which is at the heart of banking.

The reasons for market failure in financial services—such as information asymmetries or adverse selection—have long been recognized. A newer emerging literature has sought to explain the evident and growing market dualism in many financial sectors (see Dymski 2003). This literature goes beyond diagnosing simplistic market failure to recognizing the conditions that fragment markets. One 'mainstream' market which serves a particular body of consumers well, for example consumer credit, may co-exist with a parallel 'grey' but legal market comprising cash micro-lenders which serve clients denied access to the first market, but at much higher prices. The MMW question is how this fragmentation happens and how to integrate these markets over time in order to expand consumer choice away from high cost credit 'ghettos'.

Economist Robert Shiller's recent book (2002) also looks beyond conventional market failure to challenge why certain important insurance markets do not exist in a form accessible to most people. This absence results in individuals and households, even with widespread access to conventional insurance products (such as life and general insurance), not being able to offset some of the largest risks they face in life; for example, a decline in the value of their largest asset—their house—or a long run decline in pay or opportunities in their employment sector. An important reason for the non-existence of these markets historically has been the inability to collect sufficient accurate information, at a cost that would make risk underwriting feasible at a retail level. Shiller argues that advances in the storage and analysis power of information technology reduce the transaction costs and now enable these markets to develop.

Financial markets may therefore both be more prone to failure than other market types, and more amenable to the institutional economics analysis, which undergirds the MMW4P approach.

3.2 Categorization of retail financial markets

Financial markets constitute a very broad category of market. Traditional analysis differentiates between retail (directed at the individual consumer or small business) and wholesale markets (for other financial institutions or larger corporates) based on size of transactions, but the development of technology has greyed these distinctions.

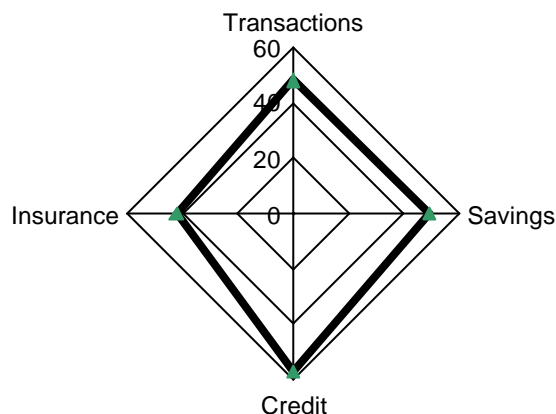
Since this paper focuses on retail financial services, it is possible to distinguish four basic market categories⁸:

- *Transaction banking*: the service offered mainly by banks which allows day-to-day transactions, in particular electronic payments to and from accounts; this category includes current accounts and most debit and ATM-card accounts, but also the provision of remittances;
- *Savings*: an external store of value for a client who intends to set aside money for a future purpose. This differs from transaction banking, in that usually savings accounts are not accessed for day-to-day purposes; included in this definition, are common products such as bank savings accounts, unit trusts, pension and provident funds, endowment funds and even informal products such as stokvel or savings club membership. Note that the product category cuts across various types of providers: banks, insurers, fund managers and others all provide savings products;
- *Credit*: the provision of an amount of money to a borrower in return for future repayments; this is a very broad category which spans all forms of consumer credit, from mortgages to micro loans, with credit cards, hire purchase and retail credit in between; and
- *Insurance*: the provision of cover against a defined risk event/s in return for the payment of a premium. This category includes conventional products such as life insurance, funeral cover, short-term insurance as well as membership of informal quasi-insurers such as burial societies. Note that insurance companies do not offer only insurance—many offer savings products as well.

Figure 3 below depicts the percentage of adult users of at least one product (formal or informal) in each category for SA in 2003, using FinScope 2003 data.

⁸ See Porteous and Hazelhurst (2004) Ch1. for more detail on this so-called 'landscape of access approach adopted by FinMark Trust

Figure 3: Landscape of Access to Financial Services in SA 2003



Source: Porteous & Hazelhurst 2004:16

The history of what is now called the micro-finance sector has involved slowly expanding to cover all the categories above, with an emphasis on their usage by poor people. In the Seventies and Eighties, the focus was on credit to the productive poor, following the public success of early micro-credit models such as Grameen Bank and Prodem (which became BancoSol). In the process, the proposition that poor people can repay credit, and that appropriate credit can provide a pathway out of poverty, was established. In the Nineties, the focus moved on to micro-savings. Based on careful analysis of poor people's financial service needs and usage patterns, thought leaders such as Stuart Rutherford demonstrated that the poor were "too poor not to save". Similarly, micro-insurance has evolved as a means of protecting vulnerability of the poor.

Transaction banking has been the last category to be added to the ambit of micro-finance. Recently, there has been particular interest in international worker remittances, which are a substantial component of international financial flows to many poor countries. However, the definition of transaction banking goes beyond remittances. FinMark Trust has especially emphasized access to transaction banking since it provides a key to unlock access to the other services: small insurance or savings premiums can be collected cost effectively from a bank account; and a third party electronic record of cash flow can be established through a bank account, which can be used to credit score accurately and cheaply an informally employed or cash paid person. Hence, the focus in the application later will be on this area.

3.3 Financial markets and poverty

Financial markets have received particular attention in the MMW4P approach because of their linkages to growth and poverty alleviation. These are set out in several recent DFID papers (Wood & Spencer 2003, DFID 2004a). Access to finance, a subset of access to broader financial services, is also given particular prominence as a pillar of an enabling approach in the recent UNDP report (2004).

Study after study has found empirical evidence of close correlation between financial sector deepening and the overall rate of economic growth. The direction of causation—i.e. that financial sector deepening causes growth—is harder to establish empirically although there is increasing evidence to this effect.⁹ This means that usage of financial services is not a follower of income growth, but may be a driver of growth. The implication is that, as part of a growth strategy alone, there is reason to promote the active development of financial markets. Beck et al (2004) go further to report cross-country macro-economic evidence that financial development has a disproportionately positive effect on the poor. This underlines the complex interactions between various markets in an economy.

The financial sector has a direct impact on poverty at the micro-economic level, primarily by affecting the ability of poor people to accumulate usefully large lump sums—whether for life cycle, emergency or opportunity investment purposes. Empirical studies of the impact of micro-finance have been reviewed elsewhere.¹⁰

3.4 Financial services and the poor

There is accumulating evidence from various countries of where and how financial services touch the lives of poor people directly. Stuart Rutherford (2002) pioneered the use of ‘financial diaries’ to record financial instrument usage by poor households over time. This approach has also been applied in India with both an urban (Ruthven 2001) and rural (Ruthven 2002) sample. Daryl Collins of UCT is currently in the field with a larger urban and rural sample in SA, and early results are available from this¹¹.

Despite diversity in conditions and different absolute levels of poverty, these studies have several core findings in common. They include:

- The underlying needs of poor households for financial services are similar to those of higher income groups;
- Poor households manage their livelihoods through a relatively large number of instruments;
- These instruments are both formal and informal—and, in fact, formal and informal services appear complementary, so that the use of informal services is not necessarily displaced at higher incomes;
- The single most used category of financial service is the taking and giving of gifts or interest free loans to friends and family—a non-market service. However, next are market-provided instruments even if informal, such as store credit, the giving of interest bearing loans and using money guards.

This last finding raises the question of the objectives of a market-development approach: does making financial markets work for the poor mean displacing such inter-personal services; or accepting that they will always be there? Using expanding choice as the guideline, poor people themselves will make this choice as options become available to them. Markets work when they

⁹ Calderon & Liu (2003)

¹⁰ Littlefield et al (2002)

¹¹ For updates on the SA Financial Diaries project, due to complete in December 2004, see www.uct.ac.za/depts/saldru

offer choices attractive and available to poor people, so that they are not forced to rely on non-market means only.

Ruthven provides a fascinating insight as to what will guide the market/ non-market choice of poor people. She found that, although the use of professional money lenders (clearly a market transaction) in a West Delhi squatter settlement was relatively limited, their services were recognized for their convenience, speed and even the dignity they provided. As one respondent said, “When I go to a money lender, it’s between him and me. I give my relatives no reason to talk” (2001:14).

Convenience and speed affect the transactions cost to the borrower: even though the money lender may charge a high interest rate, the all-in cost to the borrower of using a loan shark may be lower than, for example, a group lending scheme which requires attendance at time consuming meetings; or which is not reliable in its payouts. In assessing how markets work for the poor, one must look beyond the ‘sticker’ price to adjust for transaction costs on both sides.

The issue of dignity relates to the impact of the transaction on the social capital of the borrower and her community. Ruthven finds that certain groups in the Delhi squatter settlement, which may be poorer in absolute terms, have better access to financial services because they are part of more cohesive social groups that provide better access to their members. However, this access comes at a price. If the price is simply an inter-temporal exchange of obligations—you lend me money now that I will repay; and I will lend you money later when you need it—this may be prudent. If the price also includes loss of dignity or power manipulation, it may be too high. Again, the application of the ‘development as freedom’ metric helps resolve the question of which is appropriate or better: the test of both formal or informal, market or non-market financial services is whether they increase or limit freedom for poor people.

Despite their non-financial costs, non-market instruments typically offer cheaper alternatives to poor people than market instruments. If the usage of market-provided instruments is expanding over time, then it is reasonable to believe that people are choosing to use those services as opposed to others. Markets are therefore working for the poor, even while non-market provision continues. In making assessments of usage, there is a need to ensure that informal usage as well as formal is captured. Many market surveys have failed to do this.

3.5 Transaction bank accounts

In some poor communities, bank accounts are in fact already surprisingly pervasive—perhaps an indicator of their usefulness; or more likely, the activities of state banks. In India, Ruthven found 37% of households in the Delhi squatter settlement had one, finding it safe, but inconvenient; indeed, many had opened their bank accounts in rural areas and could not access them easily from their urban location. Collins (2004) finds on average one bank account per household in each of the three ‘financial diaries’ sites in SA, mostly used for savings or else to receive salary payments for a formally employed household member. The national survey, FinScope 2003, found that 48% of adult South Africans had a bank account—whether for savings or transaction purposes.

Bank accounts, as a particular category of financial service, will be considered further as an example of the analysis in preceding sections. This choice is not only because they serve as an anchor for the delivery of other formal financial services such as credit or insurance; but also because there is considerable data on usage and non-usage patterns in both developed and developing countries. This enables comparisons to be made across markets at different levels of development to give a sense of possible trajectories.

In the US, for example, the Survey of Consumer Finances reports that 87% of all adults had a bank account in 2001. At this high level of usage, the immediate question is: is the US market for bank accounts an example of a financial market at its natural limit, where non-users have access but choose not to exercise it; or is it close to an access frontier which could be moved outwards to work better for the poor?

Aizcorbe et al (2003) report that the percentage of families with any type of transaction account rose 0.5% between 1998 and 2001. Over an even longer horizon, the trajectory is still upwards: an improvement of almost 4% since 1992. This is evidence of an increasing usage trajectory, at least, although at a slowing pace as expected in a mature market. To establish the limit and indeed the access frontier, it is necessary to probe deeper into the reasons for non-usage. Among the 12.7% of US households without a checking account, half had had an account in the past; and almost two-thirds were in the lowest income quintile and were from US minority groups. The reasons for not having a checking account have been explored over time, and are given (and grouped by this author) in the table below.

Table 1: Reasons cited for US households not having a checking account

% of US households citing each reason

	1992	1995	1998	2001
A. Value proposition	51.6	45.3	41.3	42.6
Do not write enough checks to be worthwhile	30.4	25.3	28.4	28.6
Do not have enough money	21.2	20	12.9	14
B. Access related	28.0	27.8	30.7	27.3
Minimum balance is too high	8.7	8.8	8.6	6.5
Service charges are too high	11.3	8.4	11.0	10.2
Cannot manage or balance a checking account	6.5	8	7.2	6.6
No bank has convenient hours or location	.8	1.2	1.2	0.4
Credit problems	.7	1.4	2.7	3.6
C. Choice	18.5	23.5	24.7	27.9
Do not need or want account	3.2	4.9	6.3	5.3
Do not like dealing with banks	15.3	18.6	18.5	22.6
D. Other	1.9	3.5	3.1	2.1
TOTAL	100	100	100	100

Source: Aizcorbe et al 2003:10; categorization of questions by this author

In the table above, the detailed reasons for not having an account given in the survey have been categorized into three broad headings (ignoring other, which cannot be categorized usefully):

- Value proposition-related (42.6% in 2001): where the customer assesses the value of the service not sufficient for reasons which have to do with his/her situation; however, this is

somewhat unclear from the questions, since 'do not have enough money' may also be a statement about the cost of the service.

- Access-related (27.3%): there are impediments in the service itself, whether related to requirements, price or location.
- Choice (27.9%): these have to do with perception and volition by the consumer.

This analysis of the data suggests that access impediments are not the major reason for US households being unbanked. Over time, the choice category is growing in size, even as the basic proposition of having the account becomes more appealing (i.e. fewer people cite factors related to the inadequacy of the product proposition as a reason for not having it). A likely conclusion is that the US transaction banking market is in fact close to its access frontier and possible natural limit, which in the absence of a major change in product type or of cost subsidy, it may be hard to exceed. Indeed, levels of bank account usage exceed the 90% level in few developed countries¹².

What about developing countries at a very different level of income and stage of development? FinScope 2003 gives similar data for South Africa, where the market for transaction banking services is very different: 52% of adults do not have a bank account; and there are far fewer banks offering the service. The reasons for being unbanked were comprehensively probed. Although the survey format in this aspect is similar to the US survey quoted before, it is not the same: for one thing, the coded reasons offered were different in most cases from the US survey; and for another, FinScope allowed multiple answers to be given. This means that FinScope does not rank the seriousness of a reason, but only how many unique people selected the reason as relevant (this is why the totals for aggregated categories can sum to more than 100%). Furthermore, only a quarter of the unbanked in SA were previously banked, compared with over half in the US.

The results from FinScope are stated below, using the same categories as for the US, with a comparative US figure (after the disclaimers above) at the category level.

Table 2: Reasons for SA individuals not having a bank account

% of respondents citing the factor

	RSA 2003	US 2001
A. Value proposition	107.8	42.6
I don't have a regular income	35.6	
I don't have a job	59.8	
I earn too little to make it worthwhile	11.4	
I use someone else's bank account	1.0	
B. Access related	20.3	27.3
I don't have an identity document	2	
I don't qualify to open an account	6.1	
You have to keep a minimum balance	1.1	

¹² DFID FST Fact Sheet 1 suggests that a range of 83%-99% banked applies to the ten OECD countries reviewed.

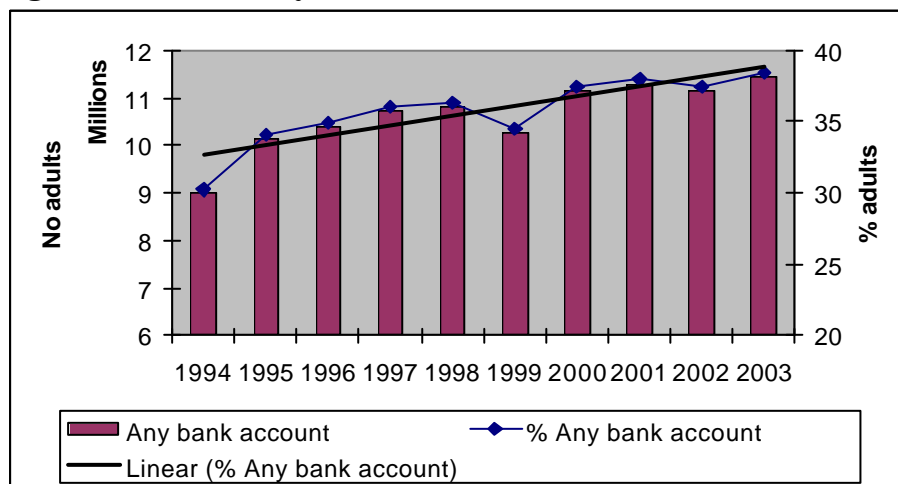
I don't know how to open an account	2.3	
Don't want to pay service fees	1.9	
The bank is too far from where I live	2.8	
It's expensive to have a bank account	4.2	
C. Choice	11.3	27.9
I don't need a bank account	5.3	
I prefer dealing in cash	4.5	
I don't trust banks	1.5	
D. Other	4.6	2.1

Source: SA: FinScope 2003; US: carried forward from Table 1

Compared with the US results reported earlier, the SA results above show that choice has much less to do with the much lower levels of usage in SA than in the US. It would seem that even direct access-related factors are on average not a major obstacle. The most common reasons given by far relate to the product not fitting the respondent's current situation (no job, no income) or vice versa. Indeed, it may be that these factors crowd out the ability of unbanked respondents to answer further, or indeed to understand more about the issues of access.

The question remains: is the transaction banking market working for the poor in SA? Figure 3 below shows absolute usage numbers and percentages of adults having any bank account over the past decade. There has been a substantial increase over the decade, as indicated by the trend line, but it also seems that progress has slowed in more recent years. The reasons behind this trajectory are discussed in more detail in Porteous & Hazelhurst (2004). The trend slowdown to stagnation, even a slight decline at the low end, has been confirmed by an unpublished supply side analysis of active low-end transaction bank accounts undertaken for FinMark Trust in 2003.

Figure 4: Users of 'any bank account' 1994-2003



Source: Porteous & Hazelhurst (2004)

Does this mean that this market is approaching an access frontier for its current structure and products? An analysis of the typical current bank account offering at the low end of the market and the profile of the unbanked market suggests that this might be so. The typical low end debit card offering has been

largely developed and marketed around a group scheme proposition: that employers can pay salaries and wages more safely and cheaply this way. Indeed, some bank accounts require the account holder to present a payslip in order to open them. The increased take-up of accounts, by low income workers, in order to receive their salaries drove much of the increase in numbers from around 9 million in 1994 to over 11 million clients today.

But in 2003, 85% of full time employed people in SA had bank accounts. That it is not 100% suggests some scope for increase in usage to include the 1.3 million full time workers currently without bank accounts. Formal employment has defined the current usage frontier; and moving usage onto the current frontier would raise the overall usage level by only 7% to 55%.

Among the unbanked in SA today, most (86%) do not have full time or part time formal employment. This does not mean that they do not have income from other sources such as self-employment or person-to-person transfers. The latter are very prevalent, especially among and within poorer households. But since private banking markets cannot be expected to provide the service for free, the question is whether and how this access frontier can be moved outwards. In the next section of this paper, the recent issue around the proposed basic bank account is used to illustrate the policy questions involved in moving the access frontier.

4. PROMOTING FINANCIAL MARKETS WHICH WORK FOR THE POOR

Section 4 Summary

- Policies to promote pro-poor financial sector development must start with analysis of the current level and trajectory of usage in a particular market.
- Next, the position of the current access frontier must be determined, together with its likely movement in the short to medium term.
- In the case of consumers whose income levels are too low for the market to serve them directly, the state may supply the service directly or force existing institutions to provide it (i.e. forced cross subsidy). The MMW4P test of such policies is whether they encourage or stunt the outward movement of the access frontier.
- The policy makers' response to the recently launched basic bank account (known as 'Mzansi') in South Africa is assessed as an illustration of the proposed approach.

4.1 Policies to move the access frontier

This section discusses policy approaches towards promoting markets which function better for the poor. Using the analysis developed and applied in the previous two sections, the policy objective may be rephrased as: How to move the market access frontier outwards in a sustainable manner as far and as rapidly as possible?

Figure 5: Raising the access frontier

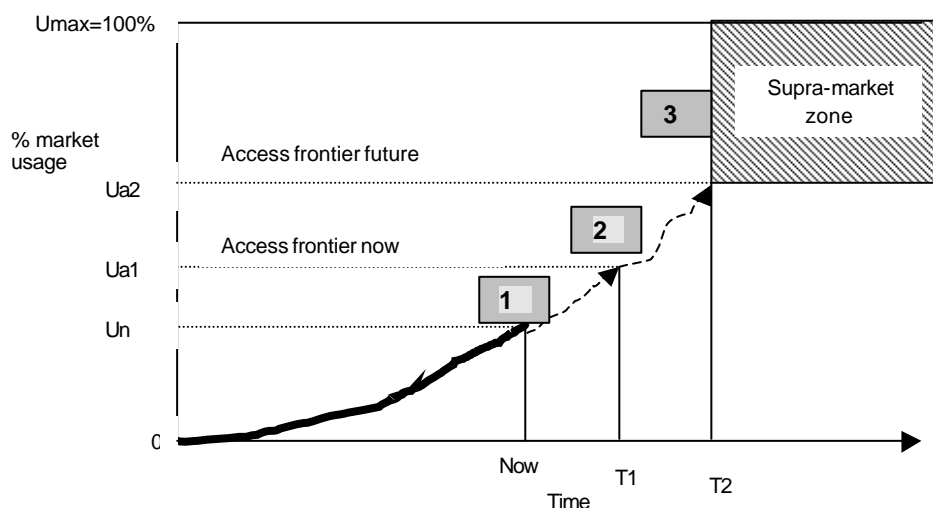


Figure 4 above, based on the earlier Figure 2, shows three zones of policy making, depending on where the current level of usage and the market trajectory is relative to the access frontier:

- Zone 1: *Market enabling policies*: Policies which move usage from current levels up to the current access frontier (U_n to U_{a1})
- Zone 2: *Market development policies*: Policies which push the access frontier outwards over time to position 2 (U_{a1} to U_{a2})
- Zone 3: *Market redistributive policies*: Policies for serving those unable to participate now or in the foreseeable future in the market (U_{a2} to U_{max}) due to lack of income.

Current usage may be relatively easy to determine by collecting the data, although, as noted earlier, the absolute level is less relevant than the trend. Where historic data does not exist, it cannot be created. It is then all the more important to set in place the measurement systems which will show trends over time in chosen markets. This may require primary survey work, which can be time consuming and costly since surveys, with statistically meaningful sample sizes, are often expensive to undertake. In small or new markets, the suppliers may not be able to fund this cost on their own; and may not be able to collaborate to share the cost without some facilitation. There is a clear case for donor and/or government support in starting the process of collecting relevant data. How to go beyond one-off surveys and make this information gathering process sustainable is harder, however, and some thoughts and experience on this are contained in Case Study 4 discussed later. In the US, the Survey of Consumer Finances, cited earlier, is undertaken triennially by the Federal Reserve Board. The financial regulator may be the logical home for such an ongoing function. Certainly, this paper proposes that policy makers need to collect further information about market usage which is not generally available if they wish to see markets work better for the poor.

To determine the current position of the access frontier, it is necessary to collect data not only on current usage but on non-usage. Research is necessary to establish why certain groups do not currently participate in the market. The barriers must be established relative to the current product set—is it a question of access or choice? If access, what are the binding conditions? Establishing the reasons, such as those reported in the previous section for not having transaction bank accounts in the US and SA, will enable the position of the current access frontier to be determined.

Once data on usage is obtained, it should be made widely available to all participants in a given market. This would promote discussion on the accuracy of the data, and lead naturally into a discussion about the trajectory of the access frontier. Are new products being planned or piloted which would access new consumer profiles? Is new technology likely to be deployed, which could affect costs? Is new legislation envisaged that may add to or reduce costs? Is new entry possible or likely in ways that would promote competition? The answers to these questions would lead to formulating a sense of the possible movement outwards, without further intervention, over the short to medium run.

From this discussion, the diagnosis of current market conditions can be confirmed; and a consensus may be built on the strategies appropriate to the circumstances. If there is a need for far reaching changes to shift the access frontier, or even move towards it, a broad consensus across market players and regulators may be necessary to manage changing expectations and avoid destabilizing the market. This is especially true given the fragility of financial markets mentioned earlier.

Much useful work has been written about market enablement, ranging from the early World Bank work on housing markets (1994) to the most recent work by Prahalad (2004). Enabling strategies typically include correcting dysfunction and removing regulatory barriers. More generally, this can be summarized as what Prahalad aptly calls ‘transaction governance capacity’ or TGC of a country. TGC is necessary for the provision of the basic requirements of a market economy: property right definition and contract enforcement. These requirements may be present *de iure* but not *de facto*. The improvement of TGC would also address the ‘dead capital’ problem Hernando de Soto (2000) has identified by clarifying and providing clear title.

Enabling strategies such as these are certainly necessary for the development of healthy markets, but may not be sufficient, as Case Study 3 on housing finance in South Africa illustrated.

Certain strategies can be either enabling or developing, depending on which ‘zone’ a market is in. For example, appropriate competitive conditions are generally a necessary condition for market enablement and development, but the nature of competition policy to achieve this will differ, depending on the stage of market development. For a market below its access frontier, competition policy would seek to address anti-competitive conditions, such as price tying and collusion, which stunt the market. For a market at or near its current access frontier, competition policy should actually encourage new entry, or at least, the threat of entry, in order to galvanize the innovation needed to reduce cost structures, and consequently push out the natural limit over time.

Increased competition always brings the risk that certain market players will fail. In the financial sector, this means that (poor) people’s savings may be placed at risk; and in extremis, due to the contagion effect, the whole financial sector may be threatened. That’s why competition policy in the financial sector is especially tricky. Bank regulators who, in practice, approve mergers and new bank licenses, face the dilemma of balancing the need for innovation to expand access, with the need for systemic stability. Usually, the balance rests too much on the side of systemic stability. The opposite extreme is not constructive either: Case Study 1 on micro-credit in SA shows the damaging effects of too much competition too fast, where free entry led to a ‘race to the bottom’ in terms of credit quality.

Financial regulators’ tendency to favour stability over disruption may be less the result of any inherent conservatism than the absence of accepted tools to assess or manage the risks created by new types of competition. Much more could be done to enable regulators to understand market development trajectories. Based on a better understanding, regulators could explore ways of encouraging innovation within acceptable risk parameters. For example, regulators could ringfence ‘innovation zones’ within regulated markets—where certain parameters are waived for a period and under a threshold size—so that the impact of failure would not destabilize the market as a whole. To prevent runaway markets, regulators could design ‘circuit breaker’ mechanisms that are activated when stated thresholds are exceeded. If these mechanisms are not thought through in advance, it is more likely that a hasty decision will be made under pressure, with perverse consequences.

There is increased competition, not only in the South African consumer credit market, but in the micro-finance sector as a whole. For example, Rhyne (2001) describes the credit bubble in Bolivia in the late Nineties. In Uganda, as a result of the development of the micro-finance market, MFIs have started competing for clients who are increasingly aware that they now have choices and can even play them off against each other (Wright & Rippey 2003). In a particular region of Kenya, Johnson (2003) has documented the rising pressure on loan pricing and terms of MFIs as a result of competition from two directions: new informal ASCAs as well as from banks seeking clients downmarket as a result of changing market conditions.

Foreign entry by larger players can change domestic markets quickly. The take-over of Uganda Commercial Bank (UCB) by Stanbic in 2002 has resulted in an aggressive technology-driven (debit card/ ATM) retail banking approach, using UCB's large existing branch network and well known brand. While it is early days, as Wright and Rippey (2003:iii) have remarked: "If Stanbic rolls out its low minimum balance savings account through its extensive network, it will change the financial services landscape in Uganda". However, entry by a strong international player is not always a panacea for increasing usage by the poor. The international player may be more likely to take easy pickings at the top end of the market, and the battle in traditional markets may distract the focus and sap the resources of incumbents to penetrate down market¹³.

In any market, a careful review of competitive policy and its implementation is required to assess whether competition levels encourage the market to work for the poor. The Cruickshank Report¹⁴, took considerable time and resources to reach a finding that there was evidence of complex monopoly in the UK payments system. The recent report of the Task Team of the Minister of Finance in SA had an even a broader mandate but far fewer resources. Its initial review is to be welcomed since it frames the broad issues of competition in SA banking. In terms of working for the poor, Chapter 7 of the report focuses on the issue of banking services to the unbanked and *inter alia* makes recommendations for removing regulatory barriers to access to the payment system for new types of banking entities.

So much for market development, which assumes an already existing market. Market creation may require government to play a catalytic role. Case Study 3, on SA housing finance, proposes that this is a role for 'new generation' development finance intermediaries (DFIs). New generation DFIs are specialized funds created with a public mandate by government but managed privately. The fund management agreement establishes incentives for management, based on the achievement of government objectives, which may be non-financial. Market creation could include funding of common costs such as information, education of clients, development of regulatory infrastructures or shared network structures. DFIs may also co-invest in industry specific access funds to promote usage in existing sectors (see Section 4.3).

Summary of Case Study 3: Housing Finance in South Africa 1994-2004

The housing policy adopted by the new SA government in 1994 was heavily influenced by the 'enabling markets approach' developed by the World Bank, and launched at a similar time. The essence of the approach was to recognize that "the sector is made up of inter-connected markets

¹³ See Genesis 2004a for further discussion on this based on survey of banking in SADC countries, many of which are foreign bank dominated.

¹⁴ See full report *Competition in UK Banking: A Report to the Chancellor of the Exchequer*, available via www.hm-treasury.gov.uk/documents

—and that intervention in these markets is essentially corrective—enabling markets to work and protecting them from failure”.

Ten years later, based on its outcomes, SA housing policy has received mixed reviews. The case study discusses whether this is because the enabling approach does not work; or whether it was insufficiently or inappropriately implemented. Even certain critics seem to suggest the latter—that enabling markets to work cannot be done in a simplistic fashion, independent of historic context or political process.

In particular, the case study discusses going beyond enablement to the creation and development of new markets, suggesting a re-oriented role for state-owned development financial intermediaries. There are a number of newly created ones, but few have been successful.

Many of the policies of market enablement and development discussed so far are conventional. The MMW framework developed here merely refines the understanding of the market context in which the policies are to be applied. However, it is in the supra-market zone where the MMW approach has the greatest policy implications. It is also in the supra-market zone where the developmental state has the keenest interest in meeting the needs of people; consequently, the pressure to find workable approaches here is increasing.

Section 2 of this paper lists four conventional strategies used by governments to extend usage of services in this zone. Applied to the financial service markets with examples, they are:

1. *provide the service directly* through a parastatal bank or government agency (post office bank)
2. *pay others* to provide the service (such as the payment to bank-linked agencies in South Africa to distribute social transfers to the poor, and even the newer plan to pay banks to open accounts)¹⁵
3. *transfer to consumers* the specific means to buy the service, such as through vouchers (an example is where the state provides an initial blocked deposit into a newly opened savings account, as for newborn children in the UK) or
4. *require existing providers to cross subsidize* the extension of the service (such as directed credit in its full blown form, or lending targets and tests in its more subtle Community Reinvestment Act format in the USA).

Of the four strategies, the first and last have been most commonly used for banking the unbanked in developed (DFID 2004b) and developing countries. Whichever is chosen, the MMW4P approach poses the question: what will it do to the access frontier over time? The policy of providing services directly, at a deeply subsidized rate through a state bank, may ‘freeze’ the market access frontier since no private player can compete beyond there. Equally, a clumsy cross-subsidy requirement could lead to market fragmentation, and could have the effect of deterring new entry and hence innovation at the bottom end of the market.

There is a fifth strategy however, which is really a derivative of the fourth above: even if they do not regulate or incentivize access directly, governments can exercise moral suasion on financial institutions. This may lead to a voluntary commitment by private financial institutions to offer a

¹⁵ For more information, see Porteous & Hazelhurst (2004: 50-52): “Social grant payments: it’s easy now”

service in this area: for example, the UK's basic bank account (BBA) offered by the high street banks to unbanked people. The voluntary nature of such commitments makes them more flexible and less onerous, but also often less effective. This is partly because the responsibility for delivery often rests with an industry body which itself cannot 'deliver' accounts; and the incentives of individual banks which can open accounts are not aligned with their other priorities. However, the state retains the right to regulate if this does not work, as it has done in the case of Belgium (DFID 2004b).

A newer sixth strategy will be introduced in 4.3. However, this analysis underlines that the role of the state as risk allocator and underwriter of markets is a key one. Moss (2002) documents, using US examples, how this role of the modern state is often little understood since it is invisible to consumers. In the US, government has over time stepped in to assume particular risks in markets; and in a number of cases, this has facilitated healthy market development.

4.2 Current state strategies for banking the unbanked in South Africa

Three of the five possible strategies listed above are in use in South Africa at present.

First, PostBank, a division of the PostOffice, which has had its operating deficits underwritten by the state, has provided basic banking services for a long time. Postbank currently has 1.2 million active clients, mainly at the low end of the market. A comparison of basic bank account product terms and prices shows that PostBank is not the cheapest (in terms of fees) or most attractive (in terms of interest rate on credit balances) bank account offering in the SA market today: several small private banks have launched competitive new products lately. While the products are new and relatively small in numbers, this is a sign that the access frontier in SA transaction banking is moving. There is a risk that a strategy of direct state provision through Postbank may crowd out further private offerings and may freeze the access frontier, locking the state into unnecessary ongoing subsidy. Even if the subsidy requirement reduces, continuing uncertainty over the future role of Postbank clouds current discussions of how private banks can serve this market and acts as a brake on movement of the access frontier in general.

A second state strategy encourages unbanked beneficiaries of state grant payments to open bank accounts to receive the benefit electronically. Currently, 6 million out of 8 million monthly recipients do not have bank accounts; and most of these rely on the state grant as their main regular income source. Similar initiatives to bank welfare recipients have been undertaken in the US and UK in recent years. These initiatives have aimed mainly to reduce the cost and increase the safety of delivery, rather than to expand usage of financial services per se. However, the way in which beneficiaries are encouraged or pressured to open bank accounts will have a major effect on the access frontier for financial services because of the sheer scale of this group: banking all six million currently unbanked (although many are children, where the target would be the parent/guardian) could raise the usage proportion by as much as 20%.

Currently, several provinces have programmes in which the state pays the monthly maintenance cost of a grant recipient's basic bank account from which she can make a certain number of free monthly cash withdrawals from ATMs or branches. Banks absorb the opening cost since they are guaranteed a regular stream of fee income and cash float resulting from the monthly state transfer. The MMW question is: how can this be done in such a way as to maximize innovation and capture scale economies?

A third privately driven strategy has been placed on the table recently. Under the moral suasion of the 2003 Financial Sector Charter, the banking sector has committed to improving effective access (not usage) to transaction banking to a level of 80% of poor people by 2008. The weight of the definition of access in practice is given to the geographic criteria—those within 20 km (now changed to 15km) of a bank service point. As a means of achieving this, the major retail banks have since 2002 been developing a product known as the basic bank account (BBA) or 'Mzansi' account.

The details of the BBA¹⁶, are documented in the Box below. The BBA is targeted at a customer niche with income levels below those of current low end bank accounts; that is, Mzansi is explicitly about pushing the access frontier.

Box 1: The Basic Bank Account

The BBA has been designed as the 'first order' bank account, which meets the basic transaction and savings needs of the LSM1-5 group, who are today largely unbanked.

It is essentially an account standard, rather than a product. Each participating bank will make available its own branded low-end product under an umbrella brand known as 'Mzansi'. The core features of the account which have been made public to date include:

- unlimited electronic transfers into the account (but no electronic payments such as debit orders)
- cash withdrawals from any SASWITCH ATM at a fixed fee per transaction, regardless of bank;
- one free monthly cash or cheque deposit
- no monthly fee
- a moderate minimum balance based interest rate structure
- discouragement of large account balances to prevent downward switching of more affluent customers.

While the account will be introduced from late 2004 as a magstripe based product, the banks intend to allow for innovation in product offering and for migration in line with EMV smart card standards.

Source: Based on Porteous & Hazelhurst 2004:33

There are several aspects of the BBA design that seek to move the current access frontier for transaction banking.

The first is the removal of the fixed monthly account service charge, which is common in SA banking. This helps to reduce the 'lumpiness' of bank accounts, especially for those with small or irregular cash flow. A regular income into a BBA, or a minimum balance, would therefore not be a pre-requisite for keeping the account open, which will increase the eligible market substantially. It should also lower bank costs by reducing the dormancy of accounts resulting from account holders losing employment.

¹⁶ Controversy over the features of the account among certain members of the Charter Council delayed finality on whether the product would qualify for Financial Sector Charter points allocation, although the launch took place on 25 October 2004.

However, the 'no monthly fee' feature may also be attractive to current users of bank accounts who may trade down to the BBA product, cannibalizing the existing bank customer base. The BBA product features have been deliberately restricted so as to reduce the risk of this.

Second, there is an envisaged cap on the number of transactions that qualify for the low transaction charge, with a higher charge for usage above this level. This enables a form of price discrimination between low volume and higher volume customers. Customers could choose to use it more (and this would be desirable for banks) but would pay more for it.

Third, the standardization of product features across banks is intended to reduce both the transaction costs to unbanked people of getting to know new product features and the marketing costs of promoting the product class.

Standardization originally extended to fixing of the retail fees. Since banks were price-setting together, this form of collusion required approval from the competition authority. However, the signal that the Ministry of Finance would view this request in an unfavourable light led to the withdrawal of the application.¹⁷ The only fixed retail price will now be for access to ATMs, which will be uniform regardless of which bank issued the card.

The BBA therefore has features that have the potential to shift the access frontier for transaction banking by appealing to new unbanked segments. The questions which remain are (i) whether it is the best way to do this; and even if not, (ii) what effect it may have on other providers and future entrants—if it succeeds or if it fails?

Already, at least one smaller bank (Capitec) has indicated that it may not join the BBA framework but will offer its own accounts. This is healthy in that it suggests that there will continue to be a variety of models on offer: BBA-type and other basic accounts. However, a purely competitive solution, in which each bank offers its own product, may not solve some of the underlying product economics issues. If the BBA cannot be at least marginally profitable to offering banks, it will not be sustained. The question is therefore, in part, under what circumstances would the product economics of BBA make sense to offering banks. This would require detailed analysis of the assumptions involved.

If the BBA is to be viable for participating banks, it must operate either with small numbers of clients (so that the loss is kept to absolute levels which can be sustained for a while at least); or with large numbers, so that BBA revenues make a positive contribution to the offering bank, in excess of the fixed costs. Clearly, the latter outcome is desired by all. However, sustained marketing and consumer education are required to create traction in the market among never banked people. The widespread positive benefits from the network effects of person-to-person money transfers, will have to be harnessed: lessons can be learnt from the way cell phone companies have incentivized people to sign up their friends and family for the service. There is value therefore in a coordinated big push by banks prepared to invest in a large marketing/ education campaign. This will incur sizeable costs and will require coordination similar to that undertaken by credit card associations in card usage campaigns on behalf of their members. Pure competition would be unlikely to result in the necessary initial push.

¹⁷ This situation is remarkably similar to the Australian case, where an application to the Competition and Consumer Commission for a generic bank account on behalf of 10 Australian Banks was rejected in 2002 (DFID 2004b).

Public interest suggests that some co-operation among providers is required at least for marketing and inter-operability requirements. However, after the initial big push to position the proposition to prospective clients—and apart from ongoing consumer education—there is good reason to allow banks, under a general framework, to tailor their own specific offerings to their strategic objectives in this market place. There is also good reason to ensure that, while there is no compulsion to join, the BBA ‘association’ remains open to new entrants who choose to join.

4.3 New generation policies for MMW4P

Because telephony was identified earlier as a desirable, even necessary, service that was beyond the affordability reach of all consumers, the telecoms industry has wrestled with similar issues of how to extend access over a longer period than the financial sector. Many of the standard redistributive policies outlined above have been employed in the telecoms sector, but often with little sustainable result and sometimes with perverse unintended consequences.

Telecoms researchers such as Wellenius (2002) and Hodge (2004) have highlighted an alternative from this sector: the creation of industry specific access funds such as the Telecommunications Development Fund in Chile or the newer Universal Access Fund in SA. Firms in the regulated sector contribute to this fund on a regular levied basis and the fund is used specifically to subsidize the expansion of access in the sector where it is currently unviable. The levy is non-refundable which allows it to be used in a flexible manner, but the ‘investments’ made may have public good-type benefits for participants in the sector. Government may or may not contribute directly to the fund; although there is a case for state development finance intermediaries to play a more active role in the financing of such funds as a complement to their sectoral investment activities.

To be sure, such a levy is a form of additional sectoral taxation that will affect the profitability of the sector as a whole. However, it is much more efficient than requiring that every organization in the sector take on low-end or unprofitable clients. The Access Fund can then be used to finance the development of common platforms and payment infrastructure—such as the association infrastructure required to launch a BBA. The Fund may even decide to finance individual firms, to develop and test innovative approaches on a matched challenge-fund type basis. The argument in favour of industry-specific funds is that, through focus and specialization, expertise may be better applied in managing such funds to develop the industry; in other words, to ensure that the access frontier moves outwards over time.

In the light of this newer strategy, the current approach to banking the unbanked could evolve beyond the launch of the BBA. It could include:

- creating the banking equivalent of the telecoms industry Universal Service Fund to which all transaction banks must contribute on a levied basis;
- the proceeds of the fund could be used to:
 - (i) reward/ incentivize those banks which succeed in taking on and keeping new low income customers, thereby helping the industry achieve its goal; and
 - (ii) cover some of the fixed costs of market development which could benefit existing banks and new market entrants. Eligible projects could include for example, promoting financial literacy in general as well as educating customers about

categories of accounts (such as the BBA or alternatives), thereby reducing individual transaction costs for both suppliers and first time account holders.

The spirit of this approach can already be seen in the commitment, by Financial Sector Charter signatories, to spend an additional 0.2% of post tax operating profits on financial literacy. However, this commitment is vaguely worded, and too narrow for the needs and opportunities. It could and should be broadened to include other access-promoting projects in the sector.

4.4 Donor roles: the need for market catalysts

This section has surveyed some of the policy implications of the MMW4P approach. There is no simple check list for making financial markets work for the poor; but the MMW4P brings a new set of policy tools to bear in seeking the answers.

To apply these tools meaningfully, the MMW4P approach requires high levels of skills and competence among policy makers and regulators, who are required to become market enablers, developers and even creators. The high skills level required for these roles may be the greatest constraint of the MMW4P approach. Beleaguered governments, with under-paid and over-worked civil servants, may be ill placed to design and implement these strategies on a broad basis.

Donors can assist in at least two ways. First, capacity building for developing country civil servants has long been a staple part of donor programmes. This paper proposes that capacity building needs to be focused on some new areas such as financial regulation and competition policy, using new tools of analysis. Existing technical assistance programmes such as FIRST could provide resources in this area.

Second, since it is usually preferable that donors do not play the role directly, they could support the development of local market catalysts in targeted markets. The role of market catalyst involves producing information, stimulating and focusing debate on the need for change in markets, as well as supporting strategies that bring the desired change, all without becoming a direct market participant. Case Study 4 describes the learning to date from FinMark Trust, as an evolving example of a donor-supported market catalyst in the SA financial market. While many of the lessons are particular to the context, which has been favourable to the engagement of a catalyst, they will still provoke questions about the nature of the catalytic role in other contexts.

Summary of Case Study 4: FinMark Trust 2002-2004

FinMark Trust was created in 2002 with funding from DFID. Its mission is to make financial markets work for the poor in southern Africa. Its role is to act as a market catalyst. The case extracts and discusses certain lessons from the experience of FinMark Trust, now more than two years old. A market catalyst must:

- be independent and credible to all market participants
- be locally owned and driven as far as possible
- consciously seek to assess wider sector trends in order to formulate engagement strategies
- ensure appropriate quality information on the market, especially the un- or under-served
- focus on a few areas for leverage, but not too early or too definitively

- have a time-dated mandate.

The heated discussion of access issues in the South African financial system have created favourable conditions for a market catalyst such as FinMark Trust to influence events; in other environments, the role of a catalyst may simply be to start the serious discussion of issues.

5. CONCLUSION

This paper has argued that MMW4P is a new and potentially useful approach to guide pro-poor economic policy making. It has sought to develop the conceptual apparatus of the approach; and has shown how it can be usefully applied at least to financial markets, using the example of South Africa.

In that particular context, the key questions were considered and addressed, in part through case studies, and the following conclusions were drawn.

- *What does it mean for markets to work for the poor?* In the simplest, most robust form, a market which works for the poor is one in which the choice of services available to the poor is expanding. This implies and requires that usage of the service among the poor, however defined, is growing; and that a range of services is available. Usage, at least, can be measured quite easily using survey data; and can be compared across sectors and companies. The usage trajectory of a particular market can and should be tracked over time.
- *Is increased access for the poor to markets always a good thing?* In general, broader access is better, but not always. Society does want to restrict markets in certain categories of goods; and, since markets are interlinked, negative externalities may arise, for example, from bubbles or 'irrational exuberance' in one market. Although there are in general self-restraining mechanisms within markets, these may be overridden.
- *Is market enablement a sufficient strategy for poverty reduction?* This depends on the definition of enablement. Certainly, the state cannot play only a passive or responsive role; a market development or market creating role is often required. Such a role will require the state to become more directly involved as facilitator and leader. This places high skills demands on the capacity of the state, and may necessitate a new generation of specialized, privately managed but state-funded development finance institutions to support the delicate business of market making.
- *How best to influence market development to become poor friendly over time?* In most cases, a catalyst will be required. The requirement is greater where there is mutual suspicion about motives and agendas between public and private sector; and where there is an imbalance in capacity between them. Donors can play a valuable role by supporting the establishment of catalysts, and keeping them true to their independent role.

These answers have been shaped by the specific context whence they come: the financial sector in South Africa. More work can be done, and indeed is being done, to flesh out the concept and its application beyond the transaction banking and consumer credit markets considered here—in areas like insurance.

The final question of this paper is therefore the extent to which these findings can be generalized to other countries and indeed to other sectors. In other words, as we 'zoom out' from the particular focus of this paper on SA and on the financial sector, what remains of its broader application, given the concern expressed in the introduction about weak generalizations that may undermine the MMW4P case?

It may be premature to suggest an answer prior to more detailed country and sectoral work. However, my initial hypothesis is that it will be easier to carry these findings across country boundaries than across sectoral boundaries. To put it another way, there are greater similarities across similar markets in different jurisdictions than across markets in the same jurisdiction. This is because the market transaction costs and externalities change radically across market types. The paper has discussed the sector which arguably bears the greatest resemblance to the financial sector—telecoms, which is also a network, is also usually heavily regulated, where greater access is seen as desirable and where there are usually a few dominant providers. There are useful insights to be drawn from the similarities, but the differences are still stark. For one thing, phone companies are not vulnerable to crises of confidence, which can bring down the whole system in a short time!

In the light of this, another potentially very useful function of donors and multi-lateral bodies is to fund work across sectors and across countries, around this theme, and ensure that the comparisons and learning takes place across borders. By carefully extracting the lessons, the general approach of MMW4P can be fleshed out further and extended.

ANNEX A: THE MMW4P APPROACH AND THE ROLE OF MARKETS

To qualify as a new approach to policy making, MMW4P must demonstrate sufficient distinctive intellectual substance and rigour. The purpose of this annexure is to document the approach and its antecedents, in order to establish this. Once this is established, subsequent sections go on to address the question of whether it is a *useful* approach, based on the power of the insights generated.

There is relatively little yet published on a general approach to MMW4P. The recent paper by Gibson, Scott & Ferrand (2004) provides the best overall framework to date. However, the authors are quick to point out that MMW4P is not a model or prescription, but an approach to policy which builds from several existing sources.

The approach has two features which distinguish it from others in the more general tradition of pro-market development. The first is that markets themselves are the main lens of analysis. The second is that markets can be, and should be, directed towards pro-poor development.

The first feature may seem obvious, but is seldom dealt with. Indeed, the existence of markets is often simply assumed or ignored in conventional economic analysis. In placing the market at the centre, the MMW approach draws on insights from the school of institutional economics. Founded on the work of Ronald Coase and Douglass North, institutional economics gives central place to the role of institutions. Institutions are understood as the constraints imposed by society: the explicit or implicit rules of that society. The market is one such key institution: a set of rules which governs exchanges for value between buyers and sellers. The cost of these exchanges—the transaction costs—plays a determinative role in shaping the institutions which evolve over time, and the impact on long run development and growth. Coase's definition of a market is framed by this understanding: "Markets are institutions that exist to facilitate exchange; that is, they exist in order to reduce the cost of carrying out transactions" (1988:7).

This understanding goes well beyond the mainstream economic view which has tended to see the market as a *deus ex machina* which, if left to its own devices, will simply and usually find the price which clears supply and demand. This price setting function, taken to the complex extremes of general equilibrium theory, has led to the powerful conclusion at the heart of neo-classical micro-economics: that social welfare is (Pareto-) optimized in perfectly working markets. However, the elegant intricacy of the methodology behind this finding has blinded many economists to the gritty reality of markets, which are very seldom anything like perfect.

To be fair, neo-classical economics does recognize conditions which lead to less than perfect outcomes. These include incomplete markets, market dominance (less than perfect competition), costly transactions and inadequate information. However, it has been less forthcoming about how to address these. For example, on the issue of desirable market structure, some economists argue that oligopolistic competition is damaging to general welfare and should be restrained in favour of having more firms; others, such as Baumol (2002), say that oligopolistic competition is the best route to technological innovation.

Institutional economics asserts that markets are much more than price setting mechanisms: in fact, prices are the outcome of the way in which markets work which is, in turn, shaped by how markets reduce transaction costs. Also, contrary to the common assumption of their existence, markets are created constructs. Coase has pointed out that markets in medieval times were usually an entrepreneurial endeavour: local entrepreneurs met the demand for safe, convenient trading places and charged a fee for their services. Since the evolution of markets is path dependent, the history of their origins and subsequent development affects their present functioning.

Application of the insight about transaction costs undergirds the MMW approach. Transaction costs are distinguished from the costs of producing a good or service, which would be the same regardless of the buyer. Transaction costs will vary uniquely for each buyer-seller exchange, and they take two main forms:

- Ex ante costs: these include the costs of search (for buyers and sellers) as well as the costs of contracting; and
- Ex post costs: which include the monitoring of a multi-period contract over time, and enforcement of rights under the contract.

The size of these costs, relative to the underlying transaction, and their distribution between buyer and seller determines the nature of the market in a good or service.

The markets for one-off transactions in goods are in many ways the simplest markets, but even they vary considerably based on the way in which transaction costs are handled. Box 1 illustrates how three goods markets—a neighbourhood yard sale, e-Bay and a craft market—which are similar in type of goods sold, have different transaction costs. This helps to categorize market types.

Box A1: Types of markets

Consider the yard sale, an e-Bay sale and Rosebank Craft Market in Rosebank, Johannesburg, all of which sell simple goods on a one-off transaction basis and yet take very different forms.

The *yard sale* is a traditional American market institution. It takes place usually in summer when households clean out unwanted items by offering them for sale from their front lawn on an advertised sale day. For the yard sale, ex ante costs are high for buyers, who need to locate the home on that one day and review the goods. The market as a result is extremely limited; and yard sale prices are typically very low. Ex post costs are very low, since the transaction is typically cash and without recourse to seller.

By contrast, *eBay* (www.ebay.com)¹⁸ provides a virtual exchange that reduces ex ante costs considerably for sellers, who can post items easily, and buyers who can search the database in seconds. The ex ante cost reduction is the first value add provided by eBay as a market. This value add enables sellers of goods, including those that could be sold via yard sale, to extract the highest price possible. Search costs are greatly reduced for buyers and sellers, resulting in a large and relatively liquid market even for obscure second hand items. In addition, eBay has added other innovations to reduce costs of contracting: for example, PayPal provides an easy medium of exchange to settle transactions, even across jurisdictions. However, since it is an electronic

¹⁸ Or for commentary on 'A perfect market', e-commerce, which eBay exemplifies, see *Economist* survey of 13 May 2004

exchange which does not deliver the goods, e-Bay buyers face ex post monitoring costs and risks—that the seller will not deliver. Hence, e-Bay’s other distinctive value add has been creating monitoring mechanisms, including seller rating, which signal reliability through reputation, and reduce costs. The rapid growth in trade volumes is the proof of the value add: over \$24 billion was traded on e-Bay in 2004, making e-Bay the largest and most liquid market of its kind.

Rosebank Craft Market (see www.finmarktrust.org.za/research) is a physical market where African craft vendors sell their wares mainly to tourists. It is not unlike a multi-family or street-wide yard sale, except that it is housed permanently in a dedicated facility and specializes in one type of good. The facility is a well located building near a major shopping mall, with a number of small stalls which vendors rent from the market manager. Before the market was built in 2001, vendors sold their wares on the street nearby the mall, and were at the mercy of the weather, and incurred substantial costs in time and energy of having to remove their goods to a safe place each night. The provision of formal market infrastructure removed these costs; it also reduced search costs for buyers since the agglomeration of vendors meant that buyers were more likely to find quickly what they were looking for, and the larger market could spread the costs of advertising in a way that individual vendors could not. However, vendors now have to pay a monthly fixed rental to the market-maker, and when FinMark Trust commissioned research in 2003, there was resentment from some vendors about this. However, the market is also able to reduce transaction costs for buyers through the provision of a credit card acceptance device, which enables tourists to spend more than if they had to carry cash with its attendant risks.

The very diversity of markets is one of the obstacles to advancing conceptual understanding. However, the following criteria would enable most market types to be distinguished:

- The nature of the transaction: is it the purchase of a good, service, factor of production, or derivative or hybrid?
- The number and type of buyer/s and sellers: Are there many or few on each side? And are they individuals or firms? Large or small?
- The price setting mechanism: Is it by negotiation, price acceptance, auction?
- The nature of rule making: Is the market subject to explicit and/or implicit rules? If so, who enforces them?

The table below applies these categories to the markets considered.

Table A1: Categorization of markets

	Types of transaction	Buyers and sellers	Price setting mechanism	Rule making
Yard sale	Goods: household goods	One or several individual sellers as a sideline; number of local buyers	Declared asking price; some negotiation	Social convention only
Ebay	Goods and services: any	Thousands of sellers who may	Auction with reserve	Explicit rules

		be individual or corporate; millions of buyers		
Rosebank craft	Goods: African crafts	80 vendors; hundreds of buyers monthly	Negotiation	Rules of market maker

In addition to categorizing the type of market, in order to develop precision in approach, it is necessary to go further and define the boundaries of a particular market under assessment. This means defining which buyers and sellers, actual and potential, are included in a particular market.

This definition has great relevance for competition strategy and policy. If for example, Coca Cola’s market is defined as the US market for cola beverages, Coke’s market share is very different from that in the global market, which might include countries where Coke is not available. If the market is, as a former Chair of the Coca Cola Company once said, for ‘share of throat’, then any liquid, water included, becomes a potential competitor in a much larger market. Such abstractions are not always helpful in practice. Competition authorities have often used empirical measures of cross elasticity—i.e. how much the sales volume of one product is affected by the change in the price of another—to determine the boundaries of a market: where elasticity is below a threshold, another market exists. However, Coke and water are likely to have some elasticity—both in developing countries where people may switch from unclean water to Coke; and in developed countries where consumers may switch the other way since bottled water (also supplied by Coke) is a healthier alternative. This illustrates some of the challenges of specific market definition.

One of the most interesting antecedent streams in the developing MMW approach has come from applied work on the housing market, undertaken at the World Bank in the early 1990s. A multi-country housing policy project—driven by thought leaders such as Stephen Mayo and Schlomo Angel, among others—started from the empirical realization that housing comes from a market or set of markets, embedded in other markets, whether policy makers recognize it or not. The markets may function better or worse in different contexts; but many pro-poor housing projects had very little impact on the way these markets worked. In fact, some projects made the environment even worse. In the seminal publication, *Enabling Housing Markets to Work*, Mayo and Angel set out an approach to enabling markets, both for country housing policy makers and for the World Bank itself. This approach has generated a subsequent programme collecting indicators of working housing markets; and has influenced housing policy in many places including post-apartheid South Africa (see Case Study 3).

In a parallel stream, the development of micro-finance in the past two decades has illustrated a similar shift: namely, that there is a widespread market for financial services, formal and informal, in which poor people participate. Narrow project interventions to spur micro-finance development will have limited impact in an otherwise hostile policy environment. As a result, micro-finance has moved from being the story of a small number of high profile individual institutions, which serve the poor successfully, to that of the workings of financial systems.

Finally, even if the market is the main unit of analysis in the MMW approach, it is important to recognize that no market exists in isolation but that complex interdependencies exist between markets. Market evolution follows from the complex feedback effects of these interactions.

As Sen points out, markets are pervasive, but not all pervasive. There are widespread alternatives to market-based exchange which are observed especially in developing economies. These include gifts as the result of altruism (as opposed to implicit barter) and intra-household production of goods and services. Because such services are not monetized, they are not usually valued in market measures of production, such as GDP, although they may be substantial. In many ways, the process of economic development is about enabling specialization and exchange. This requires splitting the all sufficient household 'atom' by requiring household members to specialize in the production of goods for sale through markets; and using the proceeds to buy in other previously in-house services, from food production to cleaning and even child care. Hence, the analysis of markets has to map the changing boundaries of markets over time.

MMW recognizes that there are self-regulating features of complex market systems, but also that these features may fail. Following his comprehensive analysis of what constitutes an enabling market environment for housing, Angel concludes: "...the housing sector (is) ...a self-organizing system, a system both largely capable of taking care of itself and permanently in need of corrective action." (Angel 2000:341)

If MMW had this one feature alone—that markets are the main focus of analysis—it would be at best a way of re-packaging the insights of institutional economics. However, a second feature distinguishes it: that markets can and should work directly *for the poor*. Previously, it was widely assumed that markets were at best indirectly relevant, and at worst, detrimental, to poor people. Indirectly, markets may generate economic growth, the fruits of which could be redistributed to the poor. However, in the process, they exploited the poor; one of the roles of the state was to protect vulnerable citizens from the ravages of markets.

MMW4P makes a bold assertion: markets can work for the poor, both as consumers and producers. Even more so, since the lives of the poor are deeply and increasingly touched by markets, markets should be harnessed to work for the poor, rather than against them. The functioning of a market should therefore be assessed *inter alia* by how it affects the lives of the poor.

The MMW4P approach is therefore closely aligned with another strand of recent discourse: a growing consensus that the private sector, not only government or donors, has a potentially important role to play in poverty reduction. The Millennium Development Goals, adopted by all UN member states in 2000, included the recognition of this need for public-private partnership for poverty alleviation.¹⁹ The recently released report of the Commission on the Private Sector and Development, to the UN Secretary General, entitled "Unleashing Entrepreneurship: Making Business Work for the Poor" builds on this theme to give it more content.²⁰

¹⁹ Under the general heading of Goal 8, "Develop a Global partnership for development", Target 12 aims to "develop further an open, rule-based predictable non-discriminatory trading and financial system"; while Target 18 aims "in co-operation with the private sector, make available the benefits of new technologies, especially information and communications".

²⁰ Available via www.undp.org/cpsd

One of the clearest recent voices arguing that there is a business reason for serving the poor has been that of US business school professor CK Prahalad. Prahalad has, since the late Nineties, been making the case for 'eradicating poverty through profits', the subtitle of his latest book²¹ which summarizes and extends his arguments in this area. Prahalad argues that multi national companies, facing saturated home markets, can find fresh opportunities serving the needs of the four billion people at the bottom of the global pyramid. But Prahalad goes further than incentivizing firms to seek 'the fortune at the bottom of the pyramid'. He argues that this market-driven process results not only in poor people being served but in broader social transformation as well: "When the poor at the BOP (bottom of the pyramid) are treated as consumers, they can reap the benefits of respect, choice, and self esteem and have an opportunity to climb out of the poverty trap" (2004:99).

Prahalad's voice may be widely known, but his argument is mainly based on favourable case studies of individual firms in particular markets. Welcome as these cases are, they are anecdotal. There is a large but vital leap to make between arguing that the actions of a particular firm, in a particular market, have had positive effects on the poor to asserting that markets can be made to work for the poor. This is the thesis of the body of this paper, using the particular case of financial markets in South Africa.

²¹ *The Fortune at the Bottom of the Pyramid* Wharton Press 2004

ANNEX B: Definitions of access to financial services

Increased access to markets is a widely stated goal; but the concept of access can be slippery to define and hence hard to measure and monitor. In particular, it can be difficult to separate the lack of access to a product from a choice not to use it. Failure to make the distinction can have serious consequences. Consider the following. The financial sector agrees with government to expand access to financial services. To achieve its commitment it introduces a new type of account which targets one of the dimensions of usage—let us say, lowering the cost. However, the take-up of the product is low. It may be concluded that clients now have access but choose not to exercise it; hence there is nothing more to be done by providers. But it could also be that the product offered is unsuitable (i.e. the providers have more work to do) or that the goal of increasing access in the defined way is simply not shared by the target population (in which case, government has to re-examine its intent).

This example clearly highlights the need to move from vaguely defined general access to more specifically defined effective access. The telecommunications sector is generally ahead of the financial sector in this area, since in many countries, policy makers and/or regulators have set objectives for universal service (the % of households with a phone service) and universal access (to community facilities not in the home), and have had to define the term. The definitions clearly must accommodate change over time. In SA, the Universal Service Agency, established to monitor and promote the goal of universal service, has proposed the following definition of universal access to telecoms as a working telephone available 24X7

- within one km for rural areas and
- 200m in urban areas.

The USA proposes that 2% of household income be used as an affordable benchmark for access to telecoms service.

In the financial sector, Ruthven et al (2001) have assessed access in a Delhi slum using the following dimensions:

- diversity in usage;
- ability to reach reasonable terms;
- the degree of choice available.

These terms ('diversity' and 'reasonable') remain vague and subjective however.

FinMark Trust has developed a definition of effective access which has three main dimensions:

- geographic access: how far or near a consumer is from the point of service
- affordability: the cost of basic access relative to income
- product features affecting access: this is largely a negative check of those features which prohibit access.

This definition has recently been used to develop summary indicators of the level of access and applied to Swaziland (Genesis Analytics 2004b).

The Financial Sector Charter in South Africa, signed in 2003 by government and financial sector organizations, took the definition of access further still:

“2.22.1 being within a distance of 20km to the nearest service point at which first-order retail financial services can be undertaken, and includes ATM and other origination points,

- except in the case of the products and services of the long term assurance industry, where effective access, including physical access, will be in terms of the availability of these products and services, and in terms of proximity or accessibility of financial advisers to community-based infrastructure;
- 2.22.2 being within a distance of 20km to the nearest accessible device at which an electronic (other than ATM) service can be undertaken;
 - 2.22.3 a sufficiently wide range of first-order retail financial products and services to meet first-order market needs, which are aimed at, and are appropriate for, individuals who fall into the All Media Product Survey (AMPS) categories of LSM 1-5;
 - 2.22.4 non-discriminatory practices;
 - 2.22.5 appropriate and affordably priced products and services for effective take up by LSM 1-5; and
 - 2.22.6 structuring and describing financial products and services in a simple and easy to understand manner.”

It is noticeable that this definition, while comprehensive, is also quite specific in some aspects:

- there is a defined geographic component—20 kilometres (since altered to 15km)
- there is a defined user group (LSM1-5, which roughly corresponds to a below \$2 per day per head income threshold).

‘Appropriate and affordable 2.22.5’ and sufficiently wide (2.22.3) remain vague, however, and in practice may end up being ignored in favour of the easy to apply metric of distance.

Access definitions will no doubt continue to evolve but the real test is perhaps whether they can be measured. Without this, they remain little more than an expression of general intent.

CASE 1: IS INCREASED ACCESS TO MARKETS ALWAYS A GOOD THING? Micro-lending in SA 1993-2004

The case of the development of the formal micro-lending sector in South Africa invites the question of whether there should be limits to market access. Prior to 1993, consumer lending in SA was subject to an interest rate ceiling applied to almost all retail loans. Then, an exemption notice was signed into law, removing price control on small loans (below R6 000 originally). This move, which was intended to enable lending to micro-enterprises for employment creation, instead enabled a rapidly growing consumer credit industry.

Porteous & Hazelhurst (2004) give more details of the explosive growth of the micro-lending sector from 1993 onwards. Essentially, from 1993 to 1999, there were no barriers to entry; and effectively no functional regulation of micro-lending, hence supply could expand freely. At the same time, the 1994 democratic transition in the country had led to a shift in lifestyle expectations and desires on the part of the majority black population, which had largely been denied access to formal credit. This unleashed large latent demand for consumer credit for lifestyle improvement—whether through home building, clothing, education or other uses. The demand together with the unconstrained supply led to explosive growth: within six years of the exemption notice, an estimated three million people (of a working population who qualified for micro-loans of perhaps 7 million) were customers of micro-lenders. Initially, most micro-lenders were small, storefront operations. However, some grew rapidly and their evident super-profitability began to draw entry by larger, more reputable players, including banks who had avoided this ‘loan shark’ market due in part to reputation risk. As a result, competition grew in product niches and, by 2000, the interest rates on certain most contested categories of micro-loan had started to fall. This appeared to be a textbook case of enablement by the state (through removing an artificial barrier to pricing) leading to greatly expanded access in a new market; and of competition bringing lower prices over time.

Yet, as the boom in consumer credit progressed into the new decade, concerns grew on a number of fronts. Was this a credit bubble, which would burst with consequences for the stability of the financial system? Were consumers being ripped off by predatory lenders with aggressive selling tactics? Were first time consumers ignorant of the consequences of excessive debt; and irrational about taking on excessive debt, relative to their income expectations? Statistics were cited about the low levels of take-home pay of some civil servants after debt service payments were deducted. Or were the sanctions for non-payment, via the court system, too weak to enforce payment obligations, encouraging reckless borrowing? Voices within government were heard to question whether greater access to consumer credit was a good thing after all. At the same time complaints grew that access to credit for housing or small enterprise purposes was denied or restricted. Why was access to the one type of credit desirable and the other not?

Adam Smith shared (or perhaps created) some of the concerns of policy makers when two hundred years earlier, in his seminal work *The Wealth of Nations*, he opposed an outright ban on interest but, contrary to the spirit of free enterprise espoused elsewhere in the book, argued for a cap on interest rates as a means of preventing the ‘squandering of scarce capital’. This was an

important early recognition of market externalities: that social loss may come from pursuing private gain.

The concerns in SA led to two moves by government. The first, in 1999, was the promulgation of a revised Usury Act Exemption which created a regulator for the exempt micro-loan sector. Registration and the payment of an initial and annual fee (to pay the cost of regulation) was now necessary for entry to the sector. Rule breakers could be de-registered and de-barred (in theory anyway) from the lucrative exempt market. This move was welcomed as necessary to clean up the sector. While it imposed new (transaction) costs on lenders, it also brought the prospect of stability and legitimacy to the sector. This greater legitimacy helped to entice major banks to enter the market at around this time, increasing the supply of credit and competition.

The second move by government came shortly afterwards in 2000. After some rumblings but with no formal warning, government (as employer rather than as regulator), unilaterally withdrew one of the methodologies by which micro-loans to civil servants were made. In the absence of comparable collection technologies, losses and arrears on payroll deducted loan books mounted. These losses weakened two major bank micro-lenders, which failed in succession in early 2002. The failure of the second, the country's sixth largest retail bank, triggered a run on the next largest bank, which was sound and profitable. A government guarantee to all depositors was necessary to halt the run and bring stability to the system, but the aftermath of the crisis severely debilitated the so called A2 or small bank sector and many which survived surrendered their bank licenses voluntarily. The degree of competition in SA retail banking decreased; and bank margins increased on average.

To the doomsayers, this proved that the increased access to consumer credit destabilized the financial system, and was therefore a bad thing. But the interesting questions remain: why did the usual self-regulating mechanisms of markets fail? In theory, increased competition for customers should lead to lower prices for better customers, making credit easier to afford and service; while bad customers were penalized by being denied access to credit or by being charged more; until the point where returns on lending in the sector are normalized for the risk. This had in fact started to happen in 1999/2000. Equally, if customers were indeed over-borrowing in general, relative to ability to repay, then lenders should have become more cautious in lending, increasing rates and cutting back demand. These would be the normal circuit breakers.

The answer for the failure lies in the two collection methodologies which dominated the micro-loan market—payroll deduction and PIN card lending—which overrode the normal circuit breakers. These methodologies created the perception of security for the lender without any further credit checking upfront. The credit performance information which would have enabled accurate and fast credit assessment upfront was not widely available, because lenders believed it was not necessary given the methodologies, hence did not provide it on their own client bases. This may not have mattered on a small scale but, as micro-lending burgeoned, lenders were effectively lending blind into a credit-pushed market. Debt burdens mounted, together with official concerns; and instead of the natural circuit breakers, the withdrawal of payroll deduction by government served as a crude circuit breaker, both in the abrupt manner of its application and the consequent unintended impact: the eventual failure of two banks. The resulting cost to the

state of bailing out depositors at one of the banks is almost certainly much higher than if the state had rather paid off all the debts of over-indebted civil servants.

This case suggests the following pointers on the desirability of increased access. Increased access is usually a good thing but over-rapid expansion of access is not sustainable. It is likely to have perverse consequences for consumers, market players such as the failed banks, and even the cause of market development as a whole: the constriction of credit supply, following the small bank crisis in 2001/2, has substantially increased the market power of remaining large players, who have been able to sustain higher prices. The natural process of market development may take a while to resume.

In particular, expanded access must be considered with caution when:

- The rate of expansion becomes unduly rapid relative to past;
- Natural 'circuit breakers' are not available or are overridden (which may be due to new technologies which are hard to assess ex ante); and
- Information which would bring about a correction is not available.

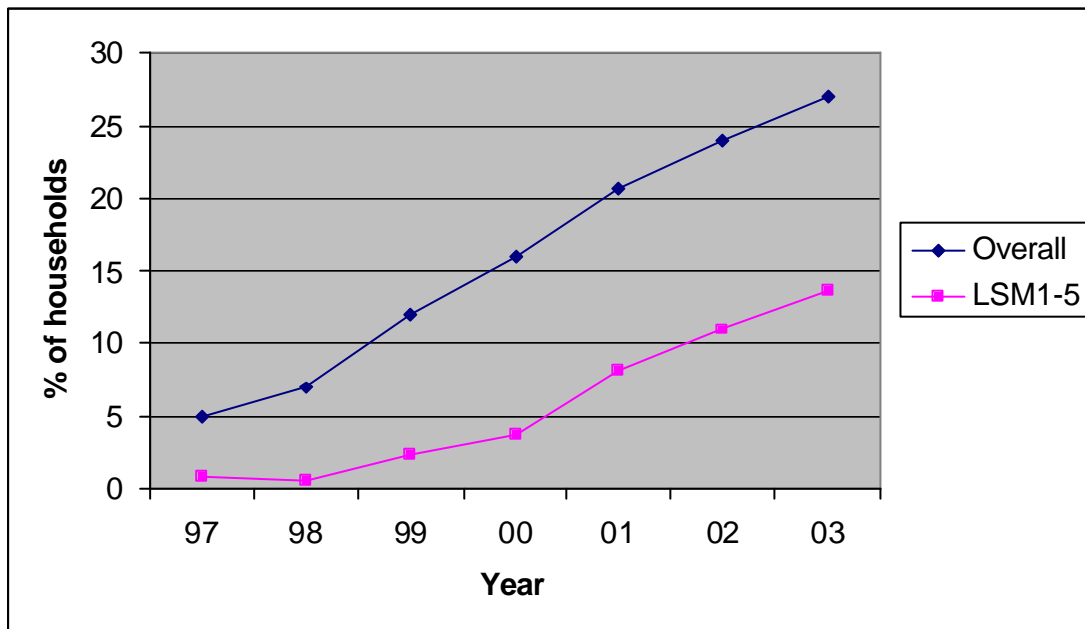
A key market development function is the design and installation of appropriate circuit breakers. For example, stock exchanges suspend trading for a period, if market movement exceeds certain thresholds, to avoid momentum alone driving prices. This requires regulators to think in advance in terms of desired trajectories of market development and about the possible risks.

CASE 2: LIMITS TO MARKETS? The cell phone industry in SA 1993-2004

The cell phone industry in SA, as in many developing countries, is an example of a market which has seen rapid growth: from a zero base in 1993 to around 10 million personal users in 2003. This was well beyond original expectations, based on the cost and high tech nature of cell phones, that the total SA market would be less than 1 million.

The market has grown in classic fashion: starting with higher income customers and extending downwards over time. In fact, the penetration of lower income groups has grown faster than the market as a whole in recent years, fuelling the overall growth rate. This is shown in Figure 1 below which uses AMPS figures on the percentage of SA adults who have personal use of a cell phone in the population as a whole, as well as the percentage in the low income LSM1-5 group, corresponding to less than \$2 income per head per day. This appears to be a market that is working for the poor using the definition proposed in the paper.

Figure 2.1: % SA adults with cell phone



Source: AMPS in each year

What are the features of the market which have brought about this outcome?

- Repackaged product: the introduction of pre-paid cell phones in around 1997 was a massive step forward in opening up the lower end market. This opened the market to those who would not have qualified for a contract, which required credit approval, since the cell phone company took the risk of non payment.
- Price discrimination: the pre-paid vs contract market distinction was a useful way of segmenting the market, based on clear product features, so that price discrimination could take place. The pre-paid market is, in fact, usually charged more per time unit but the overall size of each transaction is small and poor people are prepared to pay for the ability to be in touch even by SMS or short call.

- Reduced threshold size or lumpiness: To be accessible to poorer people, it was critical that the packages for pre-paid have the minimum possible entry cost and regular maintenance payment. The most lumpy aspect of cell phone service is usually buying the phone, but two factors worked to reduce the barrier: (i) the rise of a second hand market, linked to the network policy of providing phones free with new contracts which increased supply of new phones and decreased second hand value; and (ii) the offering of cell phones on credit through major chain stores such as Edgars, reduced the initial lumpsum cash outflow. Effectively, ongoing maintenance costs are zero, but there is a requirement for making at least one call during a time period to stay active.
- Competition: the licensing of two operators, rather than just one as in fixed line, ensured initial competition to sign up customers, which was further stoked by the licensing of a third network in 2001. Competition is starting to work through to the cost per call unit, and this is likely to be further encouraged when number portability is required, which would enable easier customer switching.

In this process, the role of regulators and regulations in promoting access for poor users to cellular telephony has been minimal. Certainly, licensing conditions for cell networks required them to make a minor contribution (maximum ZAR20m each per annum) to the Universal Access Fund and to roll out certain numbers of community call centres. This target was easily achieved but has had little impact on poor people compared with the numbers of individuals freely signing up. When further bandwidth was licensed to networks in 2003, the regulator set further conditions, requiring the distribution of large numbers of free SIM cards (Hodges 2003). This handout requires an element of cross subsidy from existing customers; however, it is also in the networks' interests to have more active customers.

The most important regulatory interventions to make this market work for the poor have been standard: increasing competition through licensing an entrant (albeit through a much less than ideal process); and requiring number portability at a future date.

The regulatory approach to cell phones, a new sector, must be contrasted with the experience in fixed line telephony, the older sector. Here, in 1996, the government agreed explicit roll out targets for the new fixed line operator, Telkom, and extended the fixed line monopoly for five years to allow cross-subsidization from existing to new users to fund the cost. Although initial rollout targets were achieved, the additional 1.6m new lines were installed at high cost, with increasing evidence of 'roll back' as users disconnect or abandon their fixed lines due to high fixed costs. The other (opportunity) costs to society from the monopoly in fixed line are higher still.

The cell phone market is still relatively new but appears to be working for the poor based on the criteria suggested. What are the natural limits of this market? Networks continue to report rapid growth, although at a slower rate, to around 16 million users in 2004. The figures must include substantial double counting across networks and within networks of dormant accounts (AMPS numbers avoid this but are only survey-based). Some industry projections estimate that the SA cell market could peak at 24m customers by 2007—this would be close to 60% of the total population. Conversations with industry executives suggest that the ultimate saturation point will be determined by the transaction costs of taking on new customers and the fixed element of

production costs. On the transaction cost, brokers are paid a commission to take on new customers; as a commission, it will vary with the size of the contract but there must be a lower limit at which the commission has value to the broker involved. The cost of providing service is largely fixed except for a small per user monthly licence fee to the technology provider. As long as the network makes more in revenue than this fee, and the distributor makes an absolute amount large enough to warrant each deal, the marginal benefit of signing on new, lower value customers will be positive; and growth of usage will continue in this market.

CASE 3: IS ENABLING MARKETS TO WORK SUFFICIENT FOR THEM TO WORK FOR THE POOR? Housing policy in SA 1994-2004

The housing policy adopted by the new SA government in 1994 was heavily influenced by the 'enabling markets approach' developed by the World Bank and launched at around the same time. This approach, which followed the collection and analysis of housing indicators in a number of developing countries, was expounded in some depth in the 1993 Bank publication, *Enabling housing markets to work*. The essence of the new approach was to move away from piecemeal intervention by governments to create new housing for the poor, towards assessing the housing and housing policy environment as a whole, and making it more enabling. As one of the key exponents of the approach, Shlomo Angel has said (2000:340): "We (now) understand the futility of intervention in housing at the project level while the sector as a whole remains dysfunctional. We recognize that the sector is made up of inter-connected markets—and that intervention in these markets is essentially corrective—enabling markets to work and protecting them from failure."

The core elements of the post 1994 SA housing policy were:

- Stabilize the housing environment in township areas—including measures to improve infrastructure and payment levels for taxes and utilities;
- Mobilize credit—although the focus was no longer on direct state provision of retail housing finance. It had shifted to the facilitation of private finance through ameliorating risk and providing liquidity support to intermediaries through newly created para-statal institutions such as NHFC and NURCHA;
- Provide one-off capital subsidies to stimulate the supply side—in line with best practice, the new subsidy regime was transparent, fully funded by an annual budgetary appropriation.

Ten years later, the success of this housing policy has been much debated. Porteous & Hazelhurst (2004) and Khan & Thring (2003) undertake a more detailed review, especially of the housing finance angle, than is possible here. In general, there are mixed reviews.

On the one hand, the subsidy system worked well to stimulate production of well over 1 million new housing units. On the other hand, the small size, poor location and sometimes poor construction quality of these units generated considerable controversy. In terms of credit mobilization, new sub-sectors blossomed, providing incremental housing finance through micro-loans and rental housing through housing associations; but the availability of low end finance to purchase houses diminished. Accusations grew that banks were 'red lining' township areas. This led to the drafting of US Community Reinvestment Act-type legislation, not yet passed into law, which would compel all housing lenders to undertake a certain proportion of low end lending. The recent Township Residential Property Markets study reports that the re-sale market in townships operates at very low levels, even relative to other areas with similar socio-economic profiles.²²

So what does this very mixed outcome mean for an enabling approach to making markets work? Does enablement not work; or was it not sufficiently or appropriately implemented?

²² For copies of the reports and presentations, see www.finmarktrust.org.za/themes/trpm

Jones and Datta (2000) have analysed the first phase of SA housing policy (up to 1999) against the template provided by the 'Enabling Markets to Work' approach. They show how housing policy in SA included a majority of the 'do's' and avoided a majority of the 'don'ts' on the list. Their conclusion is that "(the World Bank) ...list is a useful means of gauging direction over time,...but it provides no means of knowing how these principles are to be translated into concrete policy reform. In this sense, despite implying a transition, the list is essentially static. Policy makers have to work out what form of governance is implied by an enabling strategy, how to construct a system of government to administer decentralized mandates and obtain political consensus as to the desirability of reform. Moreover, as no government is able to start from a blank page, there is likely to be considerable path dependency so that an acceptance of the list's normative principles is likely to be mixed with an understanding of previous conditions."

In essence, therefore, the problem in SA was not the approach per se, but how it was applied and how far it went. Enablement by its nature can never be list-driven since its outcome will depend on feedback loops and interdependencies, as well as unintended consequences, which will only be known as it proceeds. One of the biggest constraints on the usefulness of the enabling approach is that it requires high levels of capacity and competence from governments as policy makers and implementers. In the absence of an active and engaged role by governments, an 'auto-pilot' response is likely, which may generate perverse feedback effects.

One of the central areas of failure of enablement in SA has been in housing finance: despite the creation of numerous new state mechanisms, the negotiation of Records of Understanding with the banking sector in 1994 and again in 1999 through the Presidential Job Summit Housing Project, there has been a singular lack of large flows of commercial finance into low income housing. Debates about whether this is the result of real or merely perceived risk are fruitless, since cumulative causation sets in quickly, rendering the distinction meaningless: in the downward spiral of area red-lining, perceived risk soon becomes real, as areas decay and default losses rise; and real risks are soon enough perceived by lenders whose portfolios show high levels of default. One of the key tests of the MMW approach is whether it can respond to such vicious cycles.

Passive enablement by government is clearly not sufficient. To claim that new laws have been passed, or even enforcement of laws has improved, or even that infrastructure has been improved, will not be enough to re-start mortgage lending in an area where lenders have suffered losses in the past. Since, without private lending, the cycle of decay will continue, the state may have to go further to enable actively, for example, by initiating guarantees on initial new lending in an area. This would enable confidence to build; and would also build the information base necessary for market pricing decisions to be made. As Angel has said, "Initiating with the aim of retreating is, after all, another form of enablement" (2000:345). The problem is that institutional paralysis often prevents the retreat; and the road to enabling markets is littered with the shells of obsolete development finance institutions which have either not been able to initiate at all, or if successful, have not been able to retreat to allow sustainable markets to evolve.

One of the boundary questions in the enablement debate is therefore about the proper role of state development finance institutions (DFIs), the arms of the state that engage more actively

with market failure in particular markets as the stated justification. This question is especially relevant in SA given the expressed intent not to privatize such bodies but to use them as instruments of the developmental state.

Properly mandated and managed, DFIs can play a very valuable role as active market developers and creators. As market creators, they are mandated to take on risks which the market is not able or willing to price, in the absence of information, and then gradually withdraw as the market gains confidence based on the DFI's successful experience. Withdrawal may mean either (i) privatization to compete on equal terms with other providers (this usually happens not on success but failure when non-performing state assets are sold off at deep discounts to private management e.g SA Housing Trust/ Khayaletu Home Loans); (ii) a transition to a state-mandated fund under specialized private management (such as low cost housing developer Newhco, now managed as a fund by private development entity Inframax); or (iii) ceasing to take on new business in an area. An orderly withdrawal is not easy however, since a DFI may depend on revenue from lower risk activities to be viable in taking on higher risks. Too often, DFIs have been given impossible mandates: take higher risks **and** earn market related returns. However, the value of DFIs is that the amount of state capital at risk is usually ring fenced to the capital providers: they represent state innovation funds at the cusp of public and private sectors.

To play this role successfully therefore requires DFIs to:

- Have a clear and non-conflicted mandate from state as shareholder
- Be insulated from political interference and corruption
- Be able to attract adequate skills to engage the private sector at a high level (i.e. outside of public sector pay scales)
- Have a ring fenced capital base with appropriate risk taking parameters.

A time-dated mandate may be effective to enforce withdrawal from a market: for example, the Mortgage Indemnity Fund was explicitly designed to provide cover for 3 years only so as not to permanently divert energy from solving underlying risk conditions in township areas. It shut down on schedule, although the underlying issues had not been addressed. However, rigid time-dated mandates may be too inflexible to accommodate changing market circumstances. A more flexible new generation model of DFI may be the public fund, privately managed under a clear mandate, which incentivizes the fund manager to produce returns (financial or otherwise) in line with the shareholder's interest. Non-performance would result in the revocation of the fund management mandate, whereafter the state could assess whether to re-tender the management; or re-use the balance of funds elsewhere.

CASE 4: WHAT IS THE ROLE OF MARKET CATALYSTS? Lessons from the experience of FinMarkTrust 2002-2004

FinMark Trust was created in 2002 as the result of an agreement between DFID, which provided GBP5m over five years, and the Banking Council of SA. Its mission is 'to make financial markets work for the poor'. The original DFID project logframe, setting out the objectives from the donor, translated the mission into the overall objective of reaching 100 000 new clients with financial services over five years. FinMark Trust passed its second birthday in April 2004; and had its second annual OPR by DFID thereafter. The results of this review are positive and encouraging; but because of the short time elapsed, no overall conclusion can yet be drawn about FinMark's success or otherwise. Rather, what can be gleaned is a number of lessons from two years of intensive experimentation in the midst of a financial sector in which debates over what it means to 'work for the poor/under served' came to the forefront during the Financial Sector Charter process.

This context and its implications, have been comprehensively described in Porteous & Hazelhurst (2004) so will not be repeated here. Rather the emphasis in this case study, for the purpose of this paper, is on extracting the lessons about how financial market development may be influenced.

In the public-private process of market development, it was clear at the inception of FinMark that SA financial markets required a catalyst: an entity focused on adding energy, heat and light to the interaction between state and private sector, without itself having to be or be seen to be an enduring part of the interaction. It cannot be asserted that a catalyst is always required for market development but, if it is required, then two lessons from the FinMark experience are relevant.

Lesson 1: a market catalyst must be independent and credible to all market participants
Lesson 2: a market catalyst must be locally owned and driven as far as possible.

The first lesson may seem self evident, although it was not at the design phase: FinMark Trust was originally designed to be overseen by the Banking Council²³, the SA banking industry association and a powerful player in the interactions with government over the subsequent two years. There were good reasons for this—including donor hesitancy to create and fund a new organization, as opposed to partner credible existing ones. However, it was evident from the outset that, if FinMark Trust were perceived to be, let alone be, too closely associated with any one party, its real value as a catalyst would be limited. If there was to be any bias towards a party, it needed to be towards supporting the government, which lacked capacity and resources compared with the relatively well capacitated banking sector. To its credit, the Banking Council saw this quickly and supported a rapid transition, which led to *de facto* independence for FinMark from the early days; and *de iure* independence, in terms of trust deed and direct accountable relationship with DFID, within a year from start. Notwithstanding these changes, FinMark had to work hard early on to remove suspicions that it was merely an arm of Banking Council.

²³ In the first trust deed, the Banking Council appointed trustees, and the accountable grant agreement with DFID was actually with the Banking Council, not FinMark Trust directly.

The need for independence and credibility does not automatically require the formation of a new entity since there may be existing independent and credible bodies to which market development activities may be added.

The second lesson is really a corollary of the first: to be credible, local ownership was required, in the sense of having a strong local board of trustees as the governance mechanism; and the first CEO was local, with networks in the financial markets. While again, the principle sounds self-evident, it is harder to translate and maintain in reality. For example, local ownership brings the risk of creating the perception, if not the reality, of capture by a local interest group. As FinMark became more recognized, so pressure increased from various quarters to appoint representatives of various groups to the trustees. This pressure was resisted, on the basis that the independence of FinMark came from the fact that it was not a political bargaining forum, reduced to operating by consensus, nor the voice of a particular group committed to a party line, but an independent voice speaking out on the implications for the poor of various changes.

At the time FinMark Trust launched in April 2002, energy levels in the development finance sector were very low; so low, in fact that one of the first public events organized by FinMark was a 'Class of 94 reunion'—an attempt to get together a disparate range of people who had been involved in development finance in 1994 to rekindle vision and energy for the next eight years. The low was caused, in large part, by the turmoil of the micro-finance market after the failure of several banks in early 2002; as well as by a standoff in government-financial sector relations as controversial pieces of legislation such as the Community Reinvestment Bill were introduced.

However, this energy level soon changed, as a 'perfect storm' of circumstances favourable to FinMark's mission developed. It must be pointed out that FinMark did not create any of these circumstances—the roots of each were much deeper, which made them more powerful. But this circumstance highlighted the role of market catalyst: which is to recognize the 'prevailing winds' and seek to channel them constructively where possible.

Lesson 3: consciously assess the underlying trends in order to formulate engagement strategies that harness other energy

The 'perfect storm' of circumstances was a combination of:

- Increasing government pressure on the issue of transformation of the financial sector, especially in hot spot sectors like housing and SMME
- Increasing pressure on private financial institutions to look for sources of growth, given flat to declining upper end markets
- Visionary leadership of private sector and government: the leaders on both sides saw that there was an opportunity to make a deal which would bring stability and benefits to all. Had there been intransigent leadership, compulsion would have resulted.

Instead of government resorting to the old method of compulsion, after almost a year of negotiation, the Financial Sector Charter was signed in October 2003. This voluntary compact committed the whole financial sector to wide ranging targets for transformation, including access to financial services. FinMark played a role in the process, particularly in the area of stimulating,

facilitating and provoking discussion on the issues of targets and strategies for enhancing access to financial services. FinMark-funded research was widely cited and used in this process, in part because it was the only credible source available. This suggests lesson 4.

Lesson 4: better information helps make markets work

FinMark had recognized earlier that there were important gaps in the information architecture of the retail financial sector: much was known about existing consumers but much less about unbanked people—who they were, and why were they unbanked. Hence, FinMark commenced processes of commissioning survey research that generated information which became widely cited as authoritative—the FinScope survey now in its second run in SA.

As with some of the earlier lessons, lesson 4 sounds obvious, but there were, and are, many tricky aspects to the business of information collection and dissemination, in practice. For one thing, decisions must be made about what information to collect and how to use it to influence decision making? To address this, FinMark started user groups of public and private sector managers to discuss their needs for information, and consider the usefulness of pilot surveys, which FinMark funded. This group became the heart of the first syndicate of public and private members, formed in 2003 to co-fund the first national FinScope survey. The willingness to pay for data was a strong indication that the data had value.

It also helped address another issue: one-off surveys are seldom helpful, as they do not monitor trends over time; so a way had to be found to create a sustainable ongoing survey process? Syndication proved an answer to this. FinMark underwrote the early syndication until the FinScope brand becomes widely accepted enough to be fully funded; and it will eventually be spun off as a separate entity. However, this outcome is by no means guaranteed: survey costs are typically high—as much as \$100 per respondent—and in the smaller southern African SACU markets which FinMark works, it has proven much more difficult to syndicate. In 2004, a syndicate had formed in Botswana, and a part syndicate in Namibia; but there had been no indication of willingness to pay on a sufficient scale in Lesotho and Swaziland.

FinMark Trust has devoted considerable resources to this process, but with high returns to date. These resources went far beyond money: creating the vision for the use of the information, convening syndicates, adjudicating what questions are to be included, was an important part of the process. But money was necessary: FinMark paid 100% of the 1 000 household pilot in 2002 (approx R600k), 40% of the 3 000 national household survey in 2003 (approx R500 000) and is set to fund 20% of the repeated (and improved) survey in 2004.

These relatively large numbers underline that a catalyst has to be adequately funded to play its role. The DFID grant of GBP5m over five years has to date proved an appropriate catalytic amount, given the scale of the markets to be addressed: big enough to allow traction; but not big enough to encourage false perceptions of being an independent player.

FinMark was therefore created at what turned out to be ‘the right time’ in SA financial markets. Since the DFID planning process started some two years beforehand, when this could not have been foreseen, it is important not to benchmark the impact that can be achieved in ‘perfect storm’

conditions. A benchmark must take account of what is doable in more standard conditions, such as prevail in other SACU countries. However, there is a strong case that, in any country, a careful review of the 'prevailing winds' and the collection of better quality information will enable better strategies of engagement. There is need for focus to get leverage however, which leads us to lesson 5.

Lesson 5: choose areas in which to focus efforts, but don't choose too early or too definitively.

In the first year, FinMark's agenda was deliberately open-ended, although it had identified two emerging areas where traction was possible: information creation and dissemination, as described above, and transaction banking. At the end of the first year, following the first output-to-purpose review (OPR), FinMark consciously adopted themes as areas of focus, within which it would attempt to work. Theme areas were to be selected by the trustees from time to time, based on the leverage FinMark could achieve. Importantly, theme areas were not once-for-all choices: the time frame on contracts with consultants and on projects in new areas was deliberately short (typically 6 months) so that theme areas could be substituted if no progress was being made.

Furthermore, the policy became that work was to be done outside selected theme areas by exception only.

This allowed for flexibility—or principled opportunism, as one advisor called it—which is at the heart of being a catalyst. Unforeseen circumstances will arise and the strategies of a catalyst must be flexible enough to respond.

Of course, flexibility makes measurement of success hard since the goal posts shift. This is in the nature of the work of catalysis. More fundamental, at least from a funder's standpoint, is how to measure success: how does one attribute changes to one particular intervention in complex and inter-linked markets? This leads us to Lesson 6.

Lesson 6: market development activity requires general, but measurable, overall indicators of success; too much attention to precise attribution is usually not helpful

The FinMark targets went through several evolutions. In present form, they still accommodate the funder's need for a particular format (including goal, purpose and indicators). But, in essence, they now amount to this: adding 2 million more people to the retail financial sector of SACU countries (i.e. adding some 5-10% of adults) by 2007. Why 2 million, some may ask? There is little magic in the figure, except that, in the context of the southern African financial system where most indicators of participation have been flat for a few years at least, this would be a significant trend break. It is certainly a much higher target than the 100 000 originally prescribed; but 100 000 new people would barely be a discernible blip (0.3%) on measurements of participation in a market of some 30 million adults.

Of course, FinMark cannot itself add 2 million people to the financial system; but it can seek to enhance the conditions in which this may happen. The particular 'perfect storm' circumstances

of the past two years result in some saying that this figure may be greatly exceeded. If so, this is all to the good: markets will then indeed be working better for the poor. How much influence will FinMark have had in this? This would require careful analysis of the results of FinMark efforts in particular areas: for example, if the 2 million new people are all new consumer credit clients, while FinMark has been active in promoting transaction banking and housing finance, there is a clear mismatch between effort and results. However, to require direct attribution of every outcome to the catalyst is to deny the role of a catalyst: which is sometimes indirect, and often discrete of necessity, and therefore unrecognized.

For the donor establishing market making programmes, the challenge perhaps is to set overall targets based on an assessment of what would be a decisive move forwards given (i) the starting point and (ii) given the prevailing winds. Sometimes, this cannot be done *ex ante*, until better quality information is found. In this case, project logframes have to express the principles of working markets and require quantification into objective verifiable indicators (OVIs) by a certain date after establishment. There is no reason why catalysts should not be held to close account for their activities and efforts; but measures of their success will require finer attention to circumstances than in more traditional donor projects.

Finally, as the role of FinMark came to be recognized, questions started to arise about the time-dated mandate—why should it not continue beyond 2007? For one thing, a decision to terminate in March 2007 is effectively a decision to start running down programmes from mid 2005; this can influence the desire and willingness to take on new bigger or longer projects in 2005. At the time of writing, trustees have determined to review the termination date issue by early 2005; no decision has been made. No doubt this will happen against the background of what momentum is still possible; it may be that five years is not long enough. However, one clear principle emerges:

Lesson 7: A catalyst requires a time-dated, not open-ended mandate

This means that, while the ideal life span of a catalyst must be considered carefully in local circumstances, the presumption should always be that it will terminate, rather than become a fixed point on the landscape. Without this, the catalyst is likely to hold back some of its resources to ensure its sustainability, rather than use all available energy in promoting the reactions which transform the market.

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GLOSSARY

ASCA: accumulating savings and credit rotating association

BBA: Basic Bank Account

CRA: Community Reinvestment Act (implemented for US banks, drafted and proposed but not passed in SA)

DFI: development finance intermediary

Financial Sector Charter: the voluntary agreement between financial sector, black empowerment interests and government in terms of which the sector commits to targets for black economic empowerment, including in access to financial services.

FSD: Financial Sector Development

LSM: Living Standard Measure (SA market segmentation measure in widespread usage)

MFI: Micro finance institution

MMW: Making Markets Work

MMW4P: MMW for the poor

NBA: National Bank Account, proposed in SA for low end of banking market

Stokvel: SA's name for an informal rotating savings association

Telkom: state-majority owned fixed line phone service provider in SA

UNDP: United Nations Development Programme