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The Potential of Pro-Market Activism as a Tool for Making Finance Work for Africa

A political economy perspective

Florence Dafe

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This Discussion Paper is part of a wider study on the political economy of financial reforms within the research project "Making Finance Work for Africa" commissioned by the Deutsche Gesellschaft für Internationale Zusammenarbeit (GIZ).

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Abbreviations

CBK	Central Bank of Kenya
FOGAPE	Fondo de Garantía para Pequeños Empresarios
IFIs	International Financial Institutions
KCB	Kenya Commercial Bank
NGO	Non-Governmental Organisation
SMEs	Small and Medium Enterprises

Summary

Under what conditions can government interventions in the financial sector be a successful tool to increase the financial resources available for productive investment in sub-Saharan Africa? This is the question which drives this paper. The relevance of research on this issue is widely acknowledged: There is strong empirical evidence that access to finance for private investment is essential for enterprise development and economic growth. However, most financial systems in sub-Saharan Africa are highly exclusive and poorly developed in terms of size and efficiency. The lack of financial intermediation into higher levels of domestic investment primarily results from market failures which make the provision of financial services to small and medium enterprises (SMEs) prohibitively costly or unattractive.

Historically and in line with welfare economic theory market failures have provided an argument for activism, defined as deliberate government interventions in the financial sector to promote the delivery of financial services to segments of the private sector that are underserved. The experience with activism has been mixed at best. However, even though activism does not guarantee an increase in broad-based productive private investment, past experience suggests that achieving this goal without deliberate government interventions is difficult, if not impossible. For this reason there is a renewed interest in the question of how far government interventions in financial markets could promote finance for development.

This paper makes three main arguments.

- First, it argues that the current consensus that the effectiveness of activism depends on politics and good governance offers a realistic way forward, but that the associated policy implications remain unclear. This is due to a lack of a fully developed positive approach to government activism, and thus a framework which helps evaluating ex ante whether the government of a particular country has good enough governance to assume an activist role in the financial sector. Without such ex ante predictors, development practitioners will find it difficult to prioritise reform policies and to define an adequate role for a government, ranging from modernist (putting a strong emphasis on markets over governments) to activist. Moreover, without such a framework there is the risk of spending resources on policies which are unlikely to succeed, spreading disenchantment with aid and leaving African countries without the financial services they urgently need.

- Second, political economy could provide the theoretical foundation for a framework to assess whether government interventions in a particular country are likely to succeed: By focusing on endogenous policy choice, political economy allows the modelling of policy choices as the outcome of a bargaining process of various interest groups cutting across state and society.

- Third, political economy not only helps to evaluate the chances of a successful implementation of activist policies, but also to draw policy implications for those countries which currently are not likely to have good enough governance to successfully pursue activist policies.

The paper seeks to contribute to the development of such a political economy framework by sketching some determinants of financial policy choice as a way to begin thinking about the potential of activism in a particular country: It introduces an approach based on the existing literature on the political economy of finance in the developing world. Thereby this paper points out key determinants of financial policymaking which could be used to weigh the empirical support for using activism as a tool to increase finance for private investment in a particular country. The approach proposed in this paper seeks to explain or predict policy choices through the analysis of coalitions of interest between private banks, private companies and public agencies. The existing literature suggests that the nature of a particular coalition and its capacity to determine financial policies, are shaped by the historical organisation of the private sector and the revenue base of the state.

If the political economy analysis indicates that political conditions are such that government entities have adequate governance to pursue activist policies effectively, then there are, in line with welfare economic theory, convincing arguments for development practitioners to support experiments with well designed pro-market activist policies, such as credit guarantee schemes, as temporary devices to complement modernist approaches. It is more often than not the case that the political environment in poor countries is unfavourable to activism, so that governments should pursue alternative strategies for encouraging economic development.

Political economy suggests two major strategies for policymakers in countries with an unfavourable environment: One possibility is to try to change the power relationships within society, for instance through encouraging political entrepreneurship to empower financially excluded groups. The alternative is to work within the political environment and, for example, improve the functioning of second-best institutions, such as relationship-lending.

These arguments entail a new way of thinking about how to decide on spending resources to build inclusive financial systems, as they address questions of political feasibility which, despite the rhetoric that it is necessary to go beyond the technicalities of policymaking, have not yet received serious attention in the debate on financial reform.

1 Introduction

How can governments in the political and economic environments typical of sub-Saharan Africa intervene to increase the financial resources available for productive investment? This is the question which drives this paper. The policy relevance of research on this question is widely acknowledged: There is strong empirical evidence that an efficient and inclusive financial system is essential for private investment, and ultimately economic growth.[1] However, the majority of African financial systems are highly exclusive: In Africa[2], more enterprises than in any other part of the world report that access to finance is a major constraint to their operations, and particularly small and medium enterprises (SMEs) lack access to external investment resources (Honohan / Beck 2007, 166). Moreover, even relative to other developing countries, financial systems in Africa have remained poorly developed in terms of size and efficiency (Allen et al. 2010; Honohan / Beck 2007).

The lack of financial intermediation into higher levels of domestic investment results to a substantial extent from market failures which make providing financial services to SMEs prohibitively costly or, due to an uncompetitive market environment, unattractive.[3] The need for banks to down-scale operations and find less expensive ways of serving SMEs is limited, as banks operate very profitably: Subsidiaries of foreign banks in sub-Saharan Africa have higher returns on assets than subsidiaries of the same banks in other world regions (Honohan / Beck 2007, 36). In light of the alarming situation in the financial sectors of many African countries there is a renewed interest among policymakers in the question how governments could govern the financial sector so that it better serves the needs of the real economy.

African policymakers asking this question received different advice in different eras of economic thinking: Whereas in the 1960s and 1970s there was a consensus that developing country governments should assume an activist role and intervene directly in the financial sector to increase outreach, the dominant view in the 1980s and 1990s during the Washington Consensus was that governments should take their hands off the financial markets. Today the appropriate role of the state in the financial sector is still a controversial issue: Acknowledging that the private financial sector has often not been very successful in providing finance for productive private investment, the debate now focuses less on whether governments should intervene, but rather on the degree and the best way to intervene (Beck et al. 2009). The key proposition of the current consensus on the role of government is that governments should focus on creating an enabling environment and on supporting activist actors outside the government, thus promoting access to finance. Moreover, based on more recent experiences, it is increasingly accepted in some parts of the debate that governments could themselves assume an activist role if they have appro-

1 For an overview of the finance-growth nexus, see Levine et al. (2000) or Beck et al. (2007).

2 Unless stated otherwise, the term ‘Africa’ in this paper refers to sub-Saharan Africa.

3 While there are a number of potential constraints to the expansion of firm credit in Africa (including the limited number of bankable projects) this paper focuses on financial market failures, because opinions tend to be highly polarised on the role of public action in addressing imperfect financial markets.

priate governance (Beck et al. 2009; De la Torre et al. 2007). So far, however, there is only a dearth of research exploring the circumstances under which activist government interventions could be a successful tool to increase the financial resources available for productive investment in developing countries.

This paper makes three main arguments.

- First, it argues that while the current view on the role of government in the promotion of access to finance offers a realistic way forward towards making finance work for Africa, the associated policy implications remain unclear. The reason is the lack of a fully developed positive approach to government activism which provides a framework helping to evaluate *ex ante* whether a government has the political will and capacity for efficiently playing an activist role. This paper seeks to contribute towards developing such a framework as this would help development practitioners assess whether activist government interventions have a chance of success in a particular country.

- The second argument is that political economy could provide the theoretical foundation for such a framework, because political economy allows to model policy choices as the outcome of a bargaining process between interest groups cutting across state and society.

- The third argument is that a political economy framework would not only help evaluating the chances of efficient government interventions but could also inform policymaking in countries which currently lack the conditions to govern finance through activist policies.

These arguments build upon two strands of literature: The welfare economics argument in favour of government interventions to address market failures and an interest group model of political economy focusing on the role of state-private sector relationships. Empirically the arguments are based on experiences with activism in the developing world within and outside of Africa. Thereby this paper focuses on the role of government in banking and not in the securities market, because banks still account for the vast majority of financial sector assets in poor countries (excluding central bank assets) (Demirgüç-Kunt et al. 2008, 10).

The paper proceeds as follows: Section 2 examines in more detail the current consensus on the potential of activist government interventions to increase access to finance for private productive investment. It begins by presenting the welfare economics argument in favour of activism and proceeds with an overview of the experience with activism and of the new, more political perspective on government activism. Section 3 discusses the problems development practitioners currently face when it comes to prioritising reforms without having a positive theory of activism. Section 4 sketches some starting points for thinking about the determinants of efficient government interventions in the financial sector and explores how such a framework could inform policymaking. Section 5 concludes.

2 Activism in financial markets: Theoretical perspectives and practical experiences

This section discusses the current consensus on the potential of government activism to promote greater outreach of financial systems to the private sector. It begins by exploring the rationale for activist government interventions, and compares this welfare economics point of view to the actual experience with government activism over the past five decades. Most examples are drawn from Africa, but some also refer to Asia or Latin America, where the debate on the potential of activism has been similar. The remainder of this section discusses the role attributed to politics in the current view on activism.

Before delving into the arguments, it is necessary to offer a definition of activism, a popular term in the current debate on access to finance.[4] Since the question behind this paper is how African government officials can intervene to increase finance for productive private investment, the definition proposed here is very broad: A government is referred to as activist when it deliberately intervenes in the financial sector to promote the outreach of financial services to segments of the private sector which have been underserved. The discussion focuses on SMEs in agriculture and industry as examples for underserved segments. Although it is not only governments that can play such an activist role, but also the private sector (in particular non-governmental organisations (NGOs)) or foreign donors, if not stated otherwise activism in this paper refers to government activism.

2.1 The welfare economics argument in favour of activism

From a welfare economics point of view, there might be a case for government intervention when market failures need to be corrected. The financial sector relies heavily on gathering and processing information, as well as on the enforcement of contracts. This makes finance prone to a variety of market failures which, if not corrected, limit the outreach of financial services (Besley 1994; Stiglitz / Weiss 1981). The following examples from the market for corporate lending in developing countries shed some light on how market failures can make providing credit to SMEs prohibitively costly and less profitable than the alternative options of commercial banks, such as serving large corporations or governments.

Asymmetric information (especially adverse selection and moral hazard) and enforcement problems add substantially to the transaction costs for lenders: Due to such market failures, lenders need to spend resources to screen and assess the creditworthiness of borrowers and monitor them. In poor countries these costs are particularly high as SMEs often lack a credit history or formal and stable sources of revenue or assets which can be used as collateral.

4 For an introduction to the terminology see the World Bank report "Making Finance Work For Africa" by Honohan and Beck (2007, in particular page 7-12).

Moreover, private banks may not find it worthwhile to incur the high costs of screening and monitoring SMEs because, once these borrowers have a good credit history, they can obtain credit from other lenders, who will not have to bear the initial costs for screening. This suggests that information on creditworthiness is basically a public good, in the sense that it is non-rival in consumption and it is very costly to exclude anyone from using it. When the market fails to let banks appropriate the returns of information about their costumers, banks will under-invest in the acquisition of such information.[5]

Besides asymmetric information, enforcement problems and the public good character of borrower information, high minimum efficient scales in the provision of financial services may impede the functioning of credit markets: Credit, like the provision of other financial services, involves fixed costs and to a certain extent, increasing returns to scale. If financial markets are small, as in most African countries, the lack of economies of scale substantially adds to the unit costs of transaction. Low population densities exacerbate this problem. Moreover, high minimum efficient scales increase market concentration, which eventually – although not necessarily – reduces competition and increases prices.[6]

If the costs for providing credit are high and have a negative effect on profits, then there should be an incentive to innovate and find less expensive ways of providing credit. Yet, market failures reduce investments in credit market innovations to a point below what is socially optimal: Innovations are a public good and therefore innovators bear all the costs in case of failure, but find it difficult to prevent other investors from adopting the new technology once it has proven successful. Without the possibility to internalise more of the positive externalities they create, the incentive for private banks to invest in socially profitable but financially relatively unattractive innovations will remain low, particularly if markets are uncompetitive and easy outside options are available.

In sum, high transaction costs reduce the profitability of dealing with SMEs, particularly in light of the small amounts of money involved in transactions with these clients. More attractive alternatives, such as serving large enterprises with tangible assets that can be used as collateral and which fit to the existing business model, tend to lower the banks' incentives to reduce prices, compete for market shares in underserved segments or to innovate and find more inexpensive ways of serving SMEs. Moreover, the failures of the credit market in developing countries tend not only to reduce the supply, but also the demand for credit: If the unit costs of provision are high, credit becomes less affordable for some smaller firms such as SMEs and this in turn reduces the demand for credit from the formal banking sector.

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5 The fact that setting up credit registries usually requires banks to share credit information about borrowers also provides an explanation for the slow progress in credit registry development in sub-Saharan Africa.

6 The high degree of concentration in most of Africa's banking systems partly results from the small size of national markets. Honohan and Beck (2007, 41) report that the market share of the top three banks (concentration ratio) in each country averages 73 percent across 22 African countries, based on total assets in the latest year for which data are available. This figure compares with 60 percent for the world as a whole. The market dominance by a small number of banks, points to considerable market power which, as will be explored in section 4.1, is associated with substantial economic power and influence on political decision making.

These examples demonstrate how market failures can impede the development of inclusive financial systems. They provide an argument based on welfare economic theory and information economics that some form of government intervention going beyond financial regulation and supervision to remove market failures might increase social welfare.[7] Thereby governments should choose their policy to mitigate a particular market failure depending on the nature of this market failure, in order to achieve the best possible economic outcome.[8] For instance, if the major constraint on the operation of a payment system is a problem of scale and small market size, policies which spur regional financial integration might be appropriate. In cases where several ways of addressing a specific market failure are possible, welfare economic theory suggests that governments should seek to implement those policies which address the market failure most directly and provide the highest benefits at the lowest costs.

Thus, normative economic theory does not only provide a basis for considering activism as a way to enhance social welfare but also offers some guiding principles for choosing and designing government interventions. However, contrasting these theoretical insights with actual experiences, suggests that governments often lack the capacity or willingness to design activist policies in a way that they achieve the positive outcome predicted by the theory.

2.2 The experience with activism

Assessing the actual experience with activist policies is not straightforward: First, it is difficult to provide empirical evidence of whether economic growth or productive investment would have been higher or lower in the absence of interventions, the counterfactual. Second, convincing evidence on whether the government-supported expansion of financial services increases private investment remains limited due to the non-random nature of interventions: While private banks favour serving governments and large companies, activist policies tend to target less developed sectors and companies. The associated selection bias complicates the identification of the causal impact of activist policies on the private sector. Third, returns of activist policies may be long-term, which makes it difficult to assess the success of more recent and in the short-term sometimes even distorting activist policies.

For these reasons, the following historical overview on the experience with activism adopts a broad definition of what constitutes a successful activist policy: While a narrow definition would consider activist policies only as successful when they increase investment, economic, sectoral or enterprise development, policies are also categorised as successful in this section, if they increase the outreach of financial services to the target group.

7 For a more extensive discussion see for instance Stiglitz and Weiss (1981).

8 An early discussion of this argument provides Bhagwati (1971).

Decades of market-replacing activism

In the 1960s and 1970s governments in developing countries were expected to play a prominent role in the financial sector: In line with welfare economic theory the consensus was that the lack of bank finance for private investment was a result of market failures (Gerschenkron 1962). It was part of mainstream economic thinking that an active public sector involvement in mobilising and allocating financial resources was called for to overcome market failures in order to broaden access to finance for groups and sectors that were shut out of the formal financial market, such as poor households, agriculture and sectors depending on long-term finance. This activist approach towards financial sector development was part of a broader interventionist agenda which regarded governments as drivers of the development process and sought to replace markets which failed to generate growth and substantially reduce poverty.

The main instrument to broaden access to finance in developing countries during the period of market-replacing activism was directly providing funds through public or development banks. By the 1970s the state in developing countries owned on average 65 percent of the assets of the largest banks as compared to about 40 percent in developed countries (De la Torre et al. 2007, 13). In those countries that had adopted central planning and had nationalised the banking system, such as Guinea, Tanzania or Benin, government-owned banks even constituted the entire banking system. Governments used public or development banks to support the pursuit of their developmental agenda through the selective allocation of credit. Consistent with the market failure rationale, government-owned banks sought to focus on areas where private markets failed, such as agricultural lending (Brownbridge et al. 1998).

In theory government-owned banks might have an advantage over private banks in increasing outreach through, for instance, better access to information, exploiting economies of scale, being less risk averse or solving the problems of externalities. However, the overall experience with public banks has been negative: There is strong empirical evidence that greater government participation in bank ownership is associated with lower levels of financial development, less credit to the private sector, wider intermediation spreads, slower economic growth and recurrent fiscal drains (La Porta et al. 2002). However, there are case studies at the country-level which find that some public banks, such as the village bank system of Bank Rakyat in Indonesia (Yaron et al. 1998), the Bank for Agriculture and Agricultural Cooperatives in Thailand (Townsend / Yaron 2001) or to some extent the Botswana Development Corporation (Harvey 1998, 20) were quite successful in reaching out to their targeted clientele, while still operating financially viable.

Another major tool for broadening access in developing countries was the imposition of lending requirements which obliged private banks to allocate a certain share of their loans (often at preferential interest rates) to priority sectors or regions. In East Asia, all countries directed credit to varying degrees (Stiglitz / Uy 1996). In India, only about 20 percent of bank deposits were allocated freely, the rest had to be invested in government bonds or was directed to priority sectors such as agriculture and SMEs. In Brazil, commercial banks were required to allocate between 20 and 60 percent of their sight deposits to agriculture

(De la Torre et al. 2007, 15-16). In Africa, this form of activism was most extensive in planned economies such as Tanzania, where nationalised banks provided direct credit allocations to public enterprises and priority sectors on the basis of their annual plans. Yet, even in countries where banks were relatively independent of the government, private banks were pressed to extend loans to public sector enterprises and government projects (Daumont et al. 2004, 40).

The experience with directed credit programmes has been negative in most developing countries: On average these programmes failed to reach their intended beneficiaries and more influential borrowers were favoured (World Bank 2005, 165). In some countries, such as Ghana or Nigeria, sectoral lending requirements were on the books, but not applied effectively (Daumont et al. 2004, 25). However, there are examples of successful directed credit programmes, although most of them from East Asia (Stiglitz / Uy 1996; Vittas / Cho 1996).

Another common tool to broaden access to finance in rural areas was to compel banks wishing to expand their networks of urban branches to also set up branches in rural areas. A prominent example is the Indian experiment of the late 1970s and 1980s, where the government imposed the so-called 1:4 license rule. This rule stated that banks could only open one branch in an already banked location if they opened four in unbanked locations (Burgess / Pande, 2005). Other countries where rural branching legislations were in place include Nigeria, Zambia and Botswana (Brownbridge et al. 1998).

The effectiveness of such legislation has at best been mixed. In Botswana and many other countries where rural branching legislation was tried, it was not enforced effectively (Brownbridge et al. 1998; Daumont et al. 2004). While the prominent rural branch expansion programme in India demised due to high bank loan default rates, it is also regarded as one of the success stories: The rule not only caused banks to open relatively more rural branches in Indian states with lower initial financial development and broadened access to finance, but also significantly reduced rural poverty (Burgess / Pande 2005).

The "modernist" period

While there are examples where market-replacing activism was successful, in most cases it was not and might even have impeded development. From the 1970s onwards it was increasingly accepted that two major assumptions of the market-replacing approach – that governments know how to replace markets and that they always seek to maximise social welfare – were flawed. A growing body of work found that public authorities in developing countries often had limited technical capacities for running financial institutions and that their willingness and capacity to govern financial institutions in a way that increases private investment depended on the interests of the political leadership (Brownbridge et al. 1998).

In response to these insights a consensus emerged in the 1980s that governments should withdraw from markets, including the financial sector. The costs of government failures were regarded as exceeding those of market failures and direct government interventions

were therefore seen as counterproductive. The new benchmark became the best-practice institutions of the industrialised economies and policies of this so-called “modernist” approach sought to transplant these institutions to the developing world (Honohan / Beck 2007, 7-12).[9] As a result developing countries around the world started liberalising and privatising their financial systems in the 1980s and 1990s.

The evidence for the effectiveness of modernism has been mixed. By the end of the 1990s countries in sub-Saharan Africa, like in other regions, had made significant progress in macroeconomic stability and bank restructuring, usually including the re-entry of foreign capital and the privatisation of banks (Beck et al. 2009, 14-15). Yet, in many African countries the institutional mechanisms needed to supervise and regulate banking in the modernist system were absent when reforms started so that the first decade of financial liberalisation was accompanied by macroeconomic instability, and liberalisation often had devastating effects on the real economy, as evident in growing disintermediation in the 1980s and early 1990s.[10]

The success in building inclusive financial systems with the modernist approach has fallen short of expectations: By the end of the 1990s access to finance in sub-Saharan Africa was still limited for those groups that were traditionally shut out of the market, such as lower income households or SMEs. The operations of the newly licensed domestic and foreign commercial banks’ have concentrated on government lending and international assets, avoiding lending to the domestic private sector and in particular to agriculture (Honohan / Beck 2007, 29-34; Chang 2009, 494-497) The experience has been similar in other world regions (Hanson 2003). In response to the overall disappointing record of both market-replacing activist and modernist approaches, the debate has shifted again, back towards more government involvement, but this time emphasising the need for pro-market orientation (De la Torre et al. 2007; World Bank 2007, 145-146).

9 The approach has been referred to as “modernist” because policies under this heading aimed at governing financial markets in the same manner as industrialised countries, focusing for instance on improving the macroeconomic environment, contractual and information frameworks in order to increase access to large-scale finance for formal enterprises (see for instance Honohan / Beck 2007, 7-12; Beck et al. 2009). Although the terms “activism” and “modernism” suggest a polarisation into two highly contrasting and incompatible approaches to financial policymaking, in most countries in the developing and the developed world activist and modernist approaches to financial reform complement each other today. Moreover, as Honohan and Beck (2007, 12) point out “sometimes it is not immediately clear whether certain policies should best be considered modernist or activist.” This paper uses these terms as they have become important reference points in the debate on financial inclusion, analogue to the terms “structuralist/interventionist” and “neoliberal/laissez faire” in more general debates on the role of the state in the market.

10 One of the most significant accounts is the case study of Nigeria by Lewis and Stein (1997).

Pro-Market Activism[11]

Over the past decade a consensus has emerged that the role of government needs to go beyond ensuring macroeconomic stability, towards building the necessary institutions for an inclusive, efficient and stable financial system. This view is informed by a more recent body of literature which provides strong empirical evidence for the key role of institutions for economic development and the removal of market failures (Rodrik et al. 2004; Acemoglu et al. 2001).

A major focus of public action has been on developing the contractual and informational framework. At the top of the agenda are collateral and bankruptcy law reforms which aim at protecting the rights of both borrowers and lenders in order to facilitate lending. Other major reforms aim at improving the court system or building alternative dispute resolution mechanisms and establishing asset and collateral registries. Public action also focuses on strengthening independent bank regulation and supervision, including the formulation and implementation of accounting and disclosure standards. Such measures not only aim at increasing the stability, but also the degree of competition and innovation of the financial system, two key determinants of outreach.

It also has become part of mainstream economic thinking that there is room for pro-market-activism as carefully designed, market-friendly government interventions in the financial sector to address specific market failures "while the fruits of ongoing institutional reform are still unripe" (De la Torre et al. 2007). In contrast to the earlier market-replacing approach, pro-market activism is based on the assumption that markets can broaden access to finance and therefore the goal of government interventions is to develop or enable markets, not to replace them (Beck et al. 2009; De la Torre et al. 2007). To improve the intermediation of financial resources into higher levels of investment, proponents of pro-market activism recommend governments to use a combination of sticks, e.g. moral suasion, and carrots, such as tax incentives. Considerations of financial sustainability have become central to the design of pro-market interventions (De la Torre et al. 2007). While it is acknowledged that government interventions might create inefficiencies in the short-term allocation of resources, the key underlying assumption is that time-bound pro-market activist policies may increase long-term productivity.

Pro-market activism can take the form of affirmative regulatory policy. One of the most prominent examples is the establishment of credit registries. Credit registries give access to clients' credit history and increase the transparency of borrower quality, which makes it

11 De la Torre et al. (2007) introduced the term "pro-market activism" in the access debate, which has also been picked up by others (see for instance Beck et al. 2009; De Luna-Martinez 2006; Ize et al. 2008). De la Torre et al. (2007) describe this new approach in detail and many of the characteristics of activism presented in this paper are based on their concept. This paper adopts a broad definition of pro-market activism because, as outlined at the beginning of the section, activism is defined more broadly as the "deliberate intervention to promote the outreach of financial services to groups of society which so far have been underserved". The term "pro-market" is used to contrast the current view with the market-replacing approach prevailing in the 1960s and 1970s.

safer for financial institutions to lend to new customers. They also allow borrowers to build reputational collateral which increases their bargaining power for the terms of credit. Banks are not always supportive of building credit registries, if doing so will entail the compulsory sharing of their information with other lenders which increases competition. In some countries the authorities have therefore started to push beyond what bankers are comfortable with. In Kenya, for instance, a private operator struggled for several years to initiate a credit registry due to the lack of interest among banks. The Kenyan Central Bank (CBK) took the initiative and issued a regulation which mandated financial institutions to share information with credit bureaus. Similar approaches were taken in Ghana and Uganda (Mylenko 2007). While these examples show that activism can be successful in addressing coordination failures and first mover disincentives, the fact that reforming or establishing credit registries stagnates in the majority of African countries (Beck et al. 2009), indicates that both technical capacity and political will are important intervening variables in the success of pro-market activism.

It is also increasingly acknowledged that activism might have to go beyond competition policy and first-best institution building. A case in point is the moral suasion exercised by South African authorities, causing banks to introduce the Mzansi (basic transaction) account in 2004. The Mzansi account is an entry-level deposit account offering lower charges and no overdraft facilities developed by the South African banking industry. To mitigate the financial risks of offering a low-cost account, participating banks shared the costs of product development and marketing. While the expectations of participating banks in terms of revenue (where breakeven was the expectation) were not met, they were exceeded with respect to take-up: By December 2008, more than six million Mzansi accounts had been opened, about two-thirds of which by people who had never had a bank account before (Bankable Frontier Associates 2009). Yet, there are many examples where moral suasion has not worked. For instance, frustrated by the results of earlier attempts to induce the private sector to serve each district, in 2006 the government of Uganda mandated the establishment of savings and credit cooperatives to be supported by services supplied by the poorly managed government-owned Postal Savings Bank (Beck et al. 2009, 20). The difficulties many African governments face in persuading banks to ensure the interoperability of payment system infrastructure which spurs competition, also indicate the limitations of moral suasion.

Another example for the promotion of market-friendly and activist financial governance is the key role that has recently been assigned to developing country central banks in the design and implementation of consumer protection policies.[12] It is increasingly acknowledged that this role might go beyond regulation and supervision to protect customers from potentially predatory behaviour of financial institutions: The CBK, for instance, provides an overview of bank charges to the public to facilitate comparing for customers (Candace /

12 Consumer protection has emerged as an important reform area complementary to the field of financial inclusion: Efforts to expand financial inclusion in developing countries have allowed many new customers to access the formal banking system. Yet, these new customers often have no experience in using banking services and lack an understanding of financial products, so that they are more exposed to the risk of paying excessively high interest rates and bank charges, or becoming over-indebted.

Angela 2008, 6); similarly, the Peruvian central bank requires banks to disclose the "Annual Effective Cost Rate" which is expressed like an interest rate, but includes all costs associated with a consumer credit, such as evaluation charges or credit insurance premiums (Alliance for Financial Inclusion 2010, 4). Moreover, cost information associated with financial services has to be published daily in newspapers. When this information was first published, interest rates dropped by as much as 15 percent in six months (Alliance for Financial Inclusion 2010, 3) However, as consumer protection has only recently been added to the list of priorities on the financial reform agenda, there is a lack of experience with activist consumer protection, and it is too early to more broadly evaluate the capacity and willingness of governments to intervene in the area of consumer protection.

Many governments continue using instruments which were common during market-replacing activism. Examples are credit guarantee schemes or direct public finance. Evidence of the effectiveness of these instruments in the past decade has – just like past experience – been mixed at best. In Chile, for instance, the government-owned Banco Estado has managed to broaden access to finance for micro-entrepreneurs through credit provision, while operating profitably (Benavente 2006). Benavente et al. (2006) show that the FOGAPE credit guarantee scheme funded by the Chilean government is also a success-story. African examples for successful government interventions might include the South African public business finance agency Khula Enterprise Finance, which promotes SME lending (Sapp Mancini et al. 2008, 7) and the Tanzanian SME credit guarantee scheme established by the Bank of Tanzania in 2005, which involves 50-50 risk sharing. However, in most African countries, public banks have not adjusted their business models, government schemes fail to recover loans and impose heavy fiscal costs without reaching their target groups (Honohan / Beck 2007, 99-102). So-called "smart subsidies"[13] have not yet had the expected take-up.

The examples show that it is difficult to assess the effectiveness of pro-market activism, partly because the policies have been adopted quite recently, partly because pro-market activism is a very broad and ill defined category. Yet, it is possible to draw a headline conclusion from existing experiences: There is, similarly as with regard to market-replacing activism, a broad range of examples of both successful and unsuccessful pro-market activist policies.

Remarkably, both in the past and today, developing country governments around the world have been using similar activist policies. In most countries these interventions have not achieved their goals. Yet, the fact that some countries, primarily but not exclusively in East Asia, have had successful experiences and managed to design and use the instruments in an effective way, suggests that under certain conditions, differing from country to country, activism might be a successful strategy to substantially increase the financial resources

13 One example is the initiative by a public-private alliance for financial inclusion, Banco de las Opportunidades, in Colombia: In their model subsidies for banks which open agents in rural areas are auctioned through a competitive process, with the winning bank receiving in the first year 100 percent of the subsidy, 50 percent in the second, and no subsidy in the third year.

available for productive investment. Table 1 provides a stylised summary of the different approaches to financial governance in the developing world over the past seven decades.

Table 1: Summary of approaches to financial reform in developing countries

Period	Approach to financial reform	Rationale/ ideology	Dominant or main actors	Focus of policies	Efficiency of interventions
1940s-1980s	Market-Replacing Activism	Planning; states as drivers of the development process, replacing missing or failing markets	State agencies; donors	Support of sectors and industries excluded from formal financial system, such as agriculture, SMEs and industries depending on long-term finance through directed lending, public credit, credit guarantees etc.	Overall experience negative; few examples of successful activism, primarily in East Asia
1980s-1990s	Modernism	Market-based adjustment; strong emphasis on states over markets	Private market participants; donors, especially International Financial Institutions (IFIs)	Transplantation of best-practice institutions such as central bank; independence from industrialised countries to the developing world; monetary stability; bank restructuring; market-based provision of financial services through privatisation	Evidence has been mixed; often increase in macroeconomic stability but reduced or stagnant financial intermediation
Since the end of the 1990s	Pro-Market Activism	State and markets complementary; states as market enablers and market developers	Broad spectrum of actors: developing country governments, IFIs, donors, private sector, including civil society and social entrepreneurs	Role of government goes beyond ensuring macroeconomic stability and first-best institution-building; activism might take the form of affirmative regulatory policy: mandatory information sharing with credit bureaus for financial institutions, inducing banks to share interoperability of payments infrastructures, tax incentives, smart subsidies etc.	Difficult to assess effectiveness of pro-market activism, partly because policies have been adopted quite recently; broad range of examples of both successful and unsuccessful pro-market activist policies

2.3 Politics as a key determinant of the effectiveness of activism

The past experience suggests that activism is neither a generally harmful, nor necessarily effective approach. Rather, the evidence indicates that, in line with the welfare economic argument, activism has the potential to promote finance for development if the country-specific environment is right. While a number of arguments could be made to explain the failure of government interventions in markets, such as explanations based on ideas or ideology (Krueger 1993), or on the lack of expertise to identify binding constraints (Hausmann et al. 2007), the more recent literature examining interventions in financial markets has identified politics and a lack of good governance as key determinants (Demirgüç-Kunt et al. 2008; Honohan / Beck, 2007; Stiglitz / Uy 1996, 273). There is a strong consensus that activist policies, which entail giving discretionary powers to governments, can easily be and have indeed been politically abused.

This section seeks to illustrate this perspective which is more systematically developed in the next two sections. Contrasting African and East Asian experiences with market-replacing activism illustrates what effect politics and the resulting governance structures can have on the design and implementation of activist policies – negative and positive, respectively.

In many sub-Saharan African countries no attempt was made to set clear goals for government-owned banks, to measure their performance against these goals or to undertake cost-benefit analyses (Honohan / Beck 2007, 99-107). A major reason for this lack of adequate governance structures seems to be that governments used the banking sector as a source of finance: In many cases, the practice to pay off political clients distorted the lending decisions of government-owned banks so that many of them ended up lending to the wealthy and politically connected. Often public banks were used to make up for the losses of inefficient public enterprises and central banks served to finance the state apparatus more generally (Brownbridge et al. 1998). The Uganda Central Bank, for instance, failed to adequately appraise or monitor loans or to pursue their recovery, because of the political nature of lending: The discipline of borrowers was low because they often regarded such loans as rewards for political support and in some instances politicians also told their constituents that loans from government banks need not be repaid (Nsereko 1995, 28-29). As a consequence the loan recovery rates for the lending schemes administered by Ugandan public banks were below 50 percent in the 1980s, and banks mostly failed to reach their targeted clientele (Brownbridge 1998a, 129-131).

Moreover, in many African countries positions in development banks were used by public authorities to reward political clients. This may explain why the Nigeria Education Bank, a public institution to finance the higher education sector, had failed to make a single loan seven years after it was established, despite employing 261 staff in 21 offices (Alawode et al. 2000, 55). The political costs of layoffs of excess staff were a key obstacle to the privatisation of government banks as part of the financial reform process.

Private banks in Africa also failed to serve the real economy in a way that increased broad-based private investment, and provided financial resources mainly to the govern-

ment and a small economic elite: Using political pressure, politicians and politically connected private investors in some countries appear to have been able to access loans from private banks at below market rates, to fail to repay them and to resist repayment successfully when banks took action to recover the loans. Moreover, African governments, chronically in fiscal crisis, used not only direct measures such as lending requirements to public enterprises but also indirect measures such as interest rate controls or high reserve requirements to govern private banks so as to finance the state apparatus (Brownbridge et al. 1998; Daumont et al. 2004).

At the same time, private banks, in principle opposed to such government interference in the banking sector, often came to a profitable *modus vivendi* with the government: In many African countries, such as Botswana, Kenya or Ghana private banks did not have to compete with state-owned financial institutions: The private and public banks often served different market segments, with public banks focusing on serving development priority sectors and public enterprises and private banks serving large enterprises; where private banks were required to follow sectoral credit policies, cooperation was usually bought with profitable *quid pro quos* such as central bank discounting of loans, access to inexpensive funds from government placements or controls on deposit rates that gave banks a profitable spread (Haggard / Maxfield 1993, 301; Daumont et al. 2004, 43).

The lack of adequate financial governance also had devastating costs for the technical capacities of both public and private banks: There were notable exceptions such as the Ethiopian government banks, the government-owned Kenyan Commercial Bank (KCB) or private banks in Botswana (Brownbridge et al. 1998). Yet, most African central banks lacked the necessary capacities for prudential regulation and supervision, because the financial incentives of powerful political and economic agents determined financial policymaking. Moreover, the politisation of lending decisions discouraged public and to a lesser extent private banks from building up capacities in liquidity, assets and risk management.

In contrast, the literature on the East Asian Miracle emphasises how the political leadership delegated authority to insulated economic bureaucracies (technocrats) so that they were able to develop efficient and growth enhancing economic policies.[14] As in Africa, financial policymaking was motivated by political objectives to secure power, finance the state apparatus and ensure popular acceptance, and to this end governments heavily intervened in the banking system. Yet, governance structures, incentive mechanisms and the efficiency of interventions differed substantially between Africa and the newly industrialised East Asian countries.

Nissanke (2001) describes the financial governance structure as a performance based system for the distribution of rents: Policymakers sought to create rent opportunities ("contingent rents") through the same set of financial policies as in Africa, such as interest rate controls and entry regulations. The underlying assumption was in line with welfare economic theory that in the absence of rent opportunities, banks would not have sufficient

14 For an account of the role of technocrats in economic policymaking, see Criscuolo and Palmade (2008), Winters (1996), specifically for finance see MacIntyre (1993) or Cheng (1993).

incentives to provide the socially efficient level of financial services to the private sector given the prevalence of market failures. Yet, in contrast to activist approaches in most African countries, the size of rents for banks was proportionate to their efforts in expanding their business: Rents were performance-indexed opportunities.

This governance structure appears to have created incentives for banks to expand their deposit base and improve their loan portfolio through more diligent monitoring: Unlike government-owned banks in many other developing economies, those in Korea, Singapore and Taiwan, and arguably Indonesia seem to have behaved prudently and were mostly successful in reaching their target groups (Stiglitz / Uy 1996). East Asian policymakers took several measures to minimise problems of political capture (although they were not able to eliminate them) by powerful economic interests. Taiwan gave employees of public banks incentives to act prudently and penalised employees whose loans did not perform. Korea imposed strict performance criteria to guide banks' lending decisions. In order to insulate public banks from political pressure, public officials in Malaysia were not allowed to serve on the boards of public banks (Stiglitz / Uy 1996, 258-259). In contrast to most African countries, policymakers in Northeast Asia directed credit mainly to private enterprises and changed credit policies rapidly when policies were not functioning properly (Stiglitz / Uy 1996, 271-272). Thereby, banks were given incentives to develop close links with firms and relationship-based lending allowed banks to reduce the information costs related to financial intermediation and to adopt a long-term business perspective, which increased the provision of term loans. Through the close relationship between companies, banks and a supervising and risk-taking government, the credit risks were socialised, as were the social benefits from higher private investment at a later stage of economic development (Nissanke 2001; Kang 2003).

The Northeast Asian experience highlights the importance of the governance structure activist states choose for the allocation of financial resources. There are examples showing that activism can be a viable developmental strategy in Africa, such as the case of the Botswana Development Corporation and of the KCB: Governments used these public banks to pursue their developmental agenda but made provisions that the banks were managed relatively efficiently with governments deliberately abstaining from interference in day-to-day management and ensuring that the majority of board members were private entrepreneurs (Brownbridge et al. 1998, 20-21, 84-86). While most African governments seem to have lacked the political will or capacity to design adequate governance structures which monitor and evaluate the financial sustainability of programmes and the outreach to intended beneficiaries, there is variation within sub-Saharan Africa in the degree of success in using activism as a tool to increase access to finance, depending on the political environment in which financial policymaking takes place.

Based on these experiences, the current consensus on the role of the state in the financial sector takes it as a basic premise that the political realities have to be taken into account in the design of activist policies (Beck et al. 2009; Honohan / Beck 2007, 12). While it is widely agreed that modernist approaches should be complemented through some form of activism to correct market failures and increase finance for private investment, African policymakers are often not recommended to take themselves the lead in implementing the

activist agenda by increasing their direct engagement in the provision of financial services (Honohan / Beck, 2007, 12). Rather, they are advised to smooth the way for private activists such as NGOs or social entrepreneurs. This view rests on the assumption that many African governments lack adequate governance structures (Honohan / Beck 2007, 6, 11, 12; Demirgüç-Kunt et al. 2008, 143; World Bank 1997). As the stylised comparison between African and East Asian experiences with activism highlights, appropriate governance structures seem to be the major precondition for successful market interventions: Where activism was successful, policies tended to be closely monitored and characterised by provisions that seek to hinder the political capture of policies by a powerful economic elite and the exploitation of the financial sector as a source of government finance (De la Torre et al. 2007; Stiglitz / Uy 1996).

3 Assessing the current approach towards activism

The consensus on the role of government today is distinct from the predominant views in the previous periods of market-replacing activism or modernism, in that it sees governments' main role in creating an enabling environment for financial markets. It is increasingly acknowledged that sometimes this role might have to go beyond competition policies and first-best institution-building towards affirmative regulation and other more direct interventions, whereby good governance is regarded as a key determinant of the effectiveness such policies (Honohan / Beck 2007, 12). For at least three reasons this view on activism offers a realistic and promising way forward towards making finance work for Africa.

- First, the current consensus has the potential to spur on the development of inclusive financial systems, because it has overcome the dualism of states versus markets of the Washington Consensus and sees a role for the state in improving the functioning of the market. This insight is important because it acknowledges that market failures could make the provision of financial services to some groups of society prohibitively costly and that a modernist approach alone is not likely to broaden access to finance in the medium term. It also acknowledges that at a time of unprecedented concentration of capital in a small number of banks, uncoordinated, decentralised actions by civil society, business associations for underserved sectors and social entrepreneurs are unlikely to result in substantially increased access to investment resources for SMEs or agriculture, and that the state might play an important role in negotiating and implementing large-scale, collective solutions involving public and private actors.

- Second, the current view on activism is promising because, informed by past experience, it recognises that, while globally acclaimed best-practice institutions might offer a first-best solution to market failures, transplanting them to Africa without taking into account the local political conditions is unlikely to work. There has emerged a consensus that "no size fits all" and that building best-practice institutions in Africa takes time, so that in the meantime public action could try to find alternative second-best solutions as transitional devices. This gives policymakers in countries at a lower stage of economic development more policy space.

- Third the current view on activism offers a promising way forward, because it has incorporated insights from research which identifies politics as a key explanatory variable for the success and failure of activism.[15] It is now widely accepted that the differences in the objectives and the functioning of institutions governing activist policies are due to political factors. At the core of this "institutional turn" and the renewed interest in political economy are the propositions that states and markets are politically determined and that good governance is a precondition for the success of activist policies. The current approach to activism does not deny that other country-specific factors such as ideology or the ability to identify the binding constraints in an economy, determine the effectiveness of interventions, but it is assumed that these concepts can explain only part of the cross-country variation in the effectiveness of activism and interact significantly with politics.

While the current consensus on activism provides a positive perspective on the role of government in financial markets, and offers a promising starting point for thinking about how to raise finance for investment in Africa, a major drawback remains: The associated policy implications are not quite clear. It is recognised that activism can work in principle, but it is not clear under what conditions governments are willing and capable to pursue activist policies successfully. When do political leaders choose a governance structure that on the one hand resists political capture by private interests, and on the other avoids public authorities using their political power in a way that merely benefits the state apparatus, politicians or their political supporters? It seems clear that without good governance conceived in this way, government interventions will rarely be successful. Yet, although it has become part of mainstream economic thinking that it is necessary to "get the political conditions right" before any type of government intervention, assessing *ex ante* whether a state will demonstrate adequate governance is less straightforward. This makes it difficult for donors to direct their resources for the support of activist policies only to those governments which are likely to implement them successfully.

While there is a large body of literature on the welfare economics argument in favour of government interventions, there is little research which tries to contribute to a positive theory of activism, i.e. a concept which helps evaluate *ex ante* whether a state has the willingness and capacity to pursue activist policies successfully. The small body of research in political economy which explores the determinants of financial policymaking has taken up this challenge, and allows moving closer towards such a concept of effective activism. Through its focus on endogenous policy choices, a political economy perspective would not only help to evaluate the chances for success of an activist approach, but could also inform policymaking in those countries which currently lack adequate governance to pursue activist policies successfully. There is a high added value to country-level political economy research that explores the potential of activism, because it would allow prioritising avenues for reform and as a consequence offering more effective guidance for policymakers.

15 Influential works include Haggard et al. (1993), Brownbridge et al. (1998), Daumont et al. (2004), Nissanke (2001), Fry (1994, 322) and Bhagwati (1982).

4 The potential of activism as a tool to increase finance for private investment – a political economy perspective

Contrasting positive experiences with activism in Northeast Asia with the failures in many African countries highlights the influence of politics on the effectiveness of activist policies and the need to study the political environment in which financial policymaking takes place in order to be able to explain and predict the outcome of any government intervention.

This chapter sketches some starting points for thinking about a political economy framework of activism, and demonstrates how such a framework could inform policymaking. Based on the existing literature on the political determinants of financial policymaking the chapter begins by discussing the major factors which could be used to weigh the empirical support for using activism as a tool to increase finance for private investment in a particular country. While the overall body of work on the politics of finance in developing countries is small and mainly focuses on middle-income countries in Latin America and East Asia, this literature provides a number of analytical cues on which future work on the political economy of financial reform in Africa could build on. The rest of this chapter draws some policy implications from the political perspective on financial policymaking by elaborating what reform strategies are possible in countries where the political environment is unfavourable to a successful implementation of government activism.

4.1 Policy coalitions and the politics of finance in developing countries

The most substantial body of work which seeks to explain variation in financial policymaking from a political perspective has emerged in the fields of historical institutionalism and the political economy sub-field of fiscal economy.[16] This work suggests that policy coalitions, defined as coalitions of interest cutting across state and society, play an important role in shaping financial policy patterns: State and private sector actors form implicit or explicit alliances to lobby for desired policies. Other state actors and social groups may form alliances in opposition. The difference in strength of competing coalitions then shapes policy choices. This coalitional approach to explaining financial policy rests on three key underlying assumptions:

- State-business relations are based on interdependence (Maxfield 1990; Moore / Schmitz 2008);
- Financial interests shape behaviour (Maxfield 1990; Haggard et al. 1993; Haber et al. 2008; Rajan / Zingales 2003);

16 Fiscal economy posits that the structures of complex organisations such as states, and the strategies of their managers, are influenced by the location of their resources (see for instance Goldsheid 1958).

- The translation of interests into policy is mediated by the historically evolved organisation of the private sector and the revenue base of the state (Maxfield 1990; Winters 1994; Boone 2005).

The interdependence of the state and the private sector

The proposition that state-business relations are based on interdependence is drawn from arguments about what has been termed the ‘structural power of capital’. In most developing countries there are tendencies for state predation and political capture, but also incentives for cooperation: To take the risk of investing the private sector needs the active support of the state to provide physical, social and legal infrastructure. States in turn depend structurally on private investors for two main reasons, which form the basis of the ‘structural power of capital’: First, the state apparatus depends on the inflow of financial resources to fulfil its functions and private capital providing tax income, party donations, or, in the case of banks, credit is often the primary source for this. Second, politicians need private capital to invest within their jurisdictions in order to maintain a minimum level of economic prosperity, which ensures the government popular acceptance and increases the chances of continuing in power (Moore / Schmitz 2008; Bates / Lien 1985; Winters 1996).

Private banks seem to have a privileged position among investors, not only because of their ability to withhold financial resources from government, but because they shape industrial and agricultural growth and hence macroeconomic performance more generally through channelling resources to the real economy (Thurow 1989; Zysman 1983). The structural dependence of governments on private actors, and in particular on private banks, is likely to increase their leverage over financial policy. Therefore the assumption of interdependence between the state and the private sector should serve as a starting point for thinking about the actors involved and the influence of different policy coalitions to shape financial policy.

Financial interests as determinants of behaviour

The second proposition, that financial interests shape behaviour, is a key contention underlying all major political economy approaches to explain financial policy. Common interests between sections of the public and the private sector form the foundation of different policy coalitions. Related to the first assumption of state-business interdependence, this suggests that explaining reform trajectories requires an analysis of the financial interests of actors in the public and private sphere, such as private banks, business associations, central banks and (bureaucrats within) ministries of finance.

Two issues deserve particular attention: First, the financial interests of private banks with respect to financial reforms seem to be particularly important, because bankers tend to have leverage over policy, as both the government and the productive sector rely on exter-

nal bank financing.[17] Second, in analysing the financial interests of 'the state', states should not be conceived of as monoliths, as there might be intra-state variations in financial interests, and as a result in the demonstrated willingness to pursue particular reform strategies (Maxfield 1990). For instance, it seems likely that the interests of central banks in their role as monetary authorities with a focus on financial system stability, differ from those of ministries of industry or ministries of economic development. As a result, central banks might seek to establish coalitions with different partners in the private sector than the ministries would.

The translation of interests into policy

The existing literature with a coalitional approach to explaining financial policy highlights two factors which mediate the translation of financial interests into policy:

- First, the historically determined organisation of the private sector (in particular of the banking sector) *vis-à-vis* the government, as reflected in the private sector diversity and autonomy *vis-à-vis* the state (Maxfield 1994; Boone 2005; Haggard / Maxfield 1993);
- Second, the revenue base of the state, as registered in the degree of reliance on the domestic private sector and on external sources of revenue (such as foreign capital markets, aid or exports of natural resources) for government income (Winters 1994; Winters 1996; Maxfield 1990; Rajan / Zingales 2003).

These two factors influence financial policymaking through their effect on the nature (who becomes part of a particular policy coalition) and the power (which of the competing policy coalitions are favoured in a policy process) of particular policy coalitions.

Among the most significant works exploring how the organisation of the private sector affects financial policymaking is Boone's *State, Capital and the Politics of Banking Reform in Sub-Saharan Africa* (2005). Boone (2005, 401) argues that differences in banking reform patterns reflect "cross-national differences in the strength, diversity and autonomy of private capital *vis-à-vis* the state." She demonstrates that the process of banking reform is determined by historically produced state-private sector relationships, so that reform outcomes are to a significant degree path-dependent: Government responses to pressures for financial reform in the 1980s and 1990s were conditioned by pre-existing patterns of state-society interaction, as registered in the concentration and ownership structure of the banking sector and in political alliances between the state and the banking sector. The stronger, more diverse and more autonomous the private banking sector was *vis-à-vis* the government, the further and deeper went the process of reform. Boone's findings are in line with other works on the determinants of economic policymaking in the developing world. Bräutigam et al. (2002), for instance, examine the emergence of growth coalitions

17 This argument is also at the core of resource dependency theory, a sociological theory of organisational behaviour which suggests that the external resource needs of organisations and how and by whom they can be filled helps to explain organisational behaviour (Pfeffer / Salancik 1978).

in Africa, and find that in countries where the private sector is weakly developed, it does not constitute a powerful partner in economic reform processes and government policies are less successful in economic restructuring. There is also evidence that in developing countries with highly concentrated, oligopolistic banking sectors, financial reforms are not as far-reaching, maintaining the privileges of banks, because governments try to preserve the political alliances established with these banks in pre-reform periods (Haggard et al. 1993; Boone 2005).

In light of these findings on the role of the organisation of the private sector, it seems plausible that activist policies are more likely to succeed in African countries where the state is complemented by a diverse and autonomous private (banking) sector. There are at least two reasons for this: First, governments find it more difficult to exploit the private banking sector as a source of finance for government entities, patronage or elections when it is stronger and more autonomous. Governments also have fewer incentives to do so if a developed private sector provides stable and substantial tax revenues. Second, the political capture of activist policies by powerful economic interests is less likely when the banking system is diverse and competitive. Thus, the structure of the banking sector might at least partly explain why activist policies in Kenya, which has a vibrant and competitive private banking sector, have been more successful than in Uganda, where the banking sector is still shallow, or Nigeria, where banking has only recently started to become more competitive.

However, while the analysis of historically determined state-private sector relationships carries substantial weight in explaining or predicting long-term policy patterns, it seems less suited to explain policy change: In a model where the power of different policy coalitions is entirely determined by internal, historically produced and thus relatively static institutional structures, policy is path-dependent. This makes it difficult to account for genuine financial reform and institutional innovation. Previous research on the politics of finance suggests that policy change is determined by external financial linkages, pointing to the importance of the state's revenue base: Large and relatively stable inflows of financial resources from external sources (for instance through international capital markets, exports of natural resources or, arguably, foreign aid) make the government more independent from the domestic private sector and reduce the need to seek private sector support for particular policies (Lukauskas / Minushkin 2000; Haggard et al. 1993; Moore / Schmitz 2008, 36-41).[18] Activist, business-friendly policies seem therefore more likely to be successful when governments rely substantially on the domestic private sector as a source of government income and economic prosperity, than in a context where governments rely primarily on alternative sources of revenue (Lewis / Stein 1997; Brownbridge 1998b; Winters 1996).

However, this is not to suggest that access to external financial revenues has adverse effects in all circumstances: It seems plausible that in a context of a concentrated and autonomous private sector, access to revenues from external sources (such as foreign

18 This argument can also be found in the growing body of work on the effects of oil and aid on governance on the one hand and of tax revenue on the other hand (Bräutigam et al. 2008).

credit, income from natural resources or aid) reduces the vulnerability of governments to pressures from incumbent private firms, and this might increase the policy space for governments and reduce the likelihood of the political capture of activist policies (Maxfield 1994, 587; Rajan / Zingales 2003; Moore / Schmitz 2008, 37).

This discussion of the coalitional approach to explaining or predicting policy choices suggests that a framework to weigh the empirical support for using activism as a tool to increase access to finance for productive private investment should usefully take into account the role of the historically determined organisational structure of relevant private sector institutions and the revenue base of the state. Both factors have important impacts on the structural dependence of governments on domestic capital, and on where authority resides within the government (Winters 1994).[19] As a result, both factors influence government discretion over policy making and determine which particular public sector entities gain the upper hand in the process of policymaking, as well as whether the domestic private sector (and which sections) constitutes a powerful ally in the design of activist policies. The added value of developing a coalitional approach to understanding financial policy choices is likely to be high, as few researchers have taken up this challenge (Maxfield 1990; Lukauskas / Minushkin 2000; Boone 2005).

4.2 Alternative approaches to explaining or predicting financial policy choices

The coalitional approach, which builds on historical institutionalist and fiscal economy literature to explain or predict financial policymaking, differs significantly from state- or society-centred explanations as major alternative approaches in the literature on the political economy of finance.

Society-centred approaches

Society-centred approaches perceive policy as the outcome of struggles among societal interest groups such as sectors or classes (Frieden 1991; Pagano / Volpin 2001; Rajan / Zingales 2003): Policy is conceived as an exchange where politicians provide policies favourable to those interested constituencies that their power depends on. In this analysis state interests and the state's capacity to implement policies are conceived as perfectly flexible in responding to societal preferences.

The major shortcoming of society-centred approaches is their vision of the state: The state is treated as a "black box" where the economic bureaucracy is essentially just reacting to private demands. This denies states an independent role as agenda setters proactively seeking to create alliances to gain support for their preferred policies. Successful examples of activism such as the introduction of the Mzansi account in South Africa as a result of moral suasion, or mandatory information sharing with the credit bureau in Uganda are

19 For an account of how the organisation of the private sector and the revenue base of the state determine central bank independence, and hence financial policy patterns in developing countries, see Maxfield (1994).

difficult to explain with society-centred approaches. Moreover, society-centred analyses of activism neglect the role of state capacity as a precondition for effective government action: The translation of private sector preferences into policy choices is particularly problematic in poor countries, not only because states might lack the political will, but also because they might not have the organisational, financial or knowledge resources to implement the preferred policies of private sector groups effectively (Evans et al. 1985; Thomas / Grindle 1990; Skocpol 1985; Winters 1996).

State-centred explanations: The political institutions view

In the realm of finance, state-centred explanations for financial policy choices predominantly focus on the role of political institutions for checks and balances such as electoral democracy (Haber et al. 2008; Girma / Shortland 2008; Huang 2010). The key underlying assumption of this so called political institutions view is that without self-enforcing political institutions that limit government discretion, governments, relying on banks to provide them with a source of finance, have "strong incentives to govern the financial system so as to facilitate its own political survival at the expense of the development of a banking system that can finance the private economy" (Haber et al. 2008, 2).

The major shortcoming of this approach is that it does not consider the possibility that the revenue imperative (the necessity of governments to generate income) might also provide incentives for governments to introduce universal business-friendly policies to increase tax income (Winters 1996; Moore / Schmitz 2008; Tilly 1992). Governing finance might consist of more than financing government and the relationships between those controlling capital and those with political power are characterised by both conflict and cooperation.

The assumption of causality running from political institutions to financial policy choices also appears to be problematic. One reason for this is the endogeneity of institutions. An explanation of policy choices based on institutions automatically raises the question why some states have democratic institutions and govern their financial sector well but others do not. While it seems plausible that in the long-run political institutions have the presumed positive effect, it is likely that, particularly in the short-run, there are other factors at work which determine both financial reform processes and the transition to democracy.

The increasing empirical evidence that democracy has not always had the expected positive effect on economic development and reform in the developing world also suggests that a broader set of variables than those related to political institutions might be needed to explain or predict financial development and policy patterns (see for instance Bräutigam et al. 2002; Collier / Rohner 2008). As highlighted by the previous chapters, historically those developing countries which were most successful in intervening in financial markets, such as Korea or Taiwan, were not electoral democracies (Stiglitz / Uy 1996; Kang 2003), and there is also quantitative evidence that electoral competition alone does not cause financial development (Keefer 2007; Rajan / Zingales 2003).[20]

20 There are at least two reasons why electoral democracies might not necessarily have more inclusive financial systems. First, while the majority of voters in many developing countries are currently ex-

In light of the shortcomings of state-centred and society-centred explanations for financial policy choices, the added value of elaborating a framework to weigh the empirical support for activism using a coalitional approach to explain or predict financial policy is likely to be high.

Few researchers have taken up this challenge and they mostly focused on Latin American and East Asian middle income countries (Maxfield 1990; Lukauskas / Minushkin 2000).

Table 2 provides an overview of approaches in the existing literature to study financial policy patterns. The review of society-centred, state-centred and interdependence approaches provides some guidance for building a framework to study the potential of activism as a tool to increase access to finance. The next section will further elaborate the key elements and steps in a political economy analysis to weigh the empirical support for an activist approach.

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cluded from financial services, financial policymaking does not necessarily reflect their preferences, because finance might be a topic that is removed from the sphere of political competition: Usually different parts of the state apparatus seek to fulfil the different and conflicting functions of the state. Some state organisations play leading roles within the clientelist spheres and cater to the electoral needs of the ruling parties, serving the majority of poor voters; others are more removed from political competition, as is often the case with central banks (Woodall 1996). If monetary agencies are removed from the political sphere, they are likely to prefer policies focusing on macroeconomic stability, as compared to policies seeking to increase the inclusiveness of financial systems (Haggard / Maxfield 1993). This also highlights that states should not be regarded as unitary actors and that there are intra-state variations in the capacity and willingness to pursue particular policies. Second, the link between democracy and financial inclusion is problematic because in poor countries the institutional prerequisites for the effective representation of the preferences of financially excluded groups are often missing: Excluded groups such as the SME sector and its employees are often weakly organised along institutional lines (Bräutigam et al. 2002), and "in patrimonial or personalistic regimes the potential numerical power of the votes of the poor is neutralised by their fragmentation among competing particularistic networks and interests" (Moore et al. 2003, 187), such as ethnic networks.

Table 2: Overview of approaches to explain and predict financial policy patterns in developing countries

Approach to explain/predict policies	Dominant or main actors	Main propositions	What should reformers do? Policy implications	Weakness of the approach	Exemplary works
Interdependence approaches	State actors, private sector	- Interdependence between state and society - Financial interests of political coalitions cutting across state and society are major determinants of financial policy patterns	- Engage in political economy analysis of policy coalitions to explore niches for engagement across public-private divide - Broker coalitions	- Narrow focus on historically determined organisation of the private sector sees policy choice as path-dependent and neglects international factors - Neglects the role of technical capacity	Boone 2005; Maxfield 1990
Society-centred approaches	Private sector	- Policy is the outcome of competition among societal interest groups - Policy is an exchange where politicians provide favourable policies to those interested constituencies that their power depends on	Strengthen those societal interest groups which have an interest in more inclusive financial systems	State interests and capacity to implement policies assumed perfectly flexible: - States as preference-takers not preference makers - Dismisses the role of state capacity	Pagano / Volpin 2001; Rajan / Zingales 2003

Table 2: Overview of approaches to explain and predict financial policy patterns in developing countries (continued)

Approach to explain/predict policies	Dominant or main actors	Main propositions	What should reformers do? Policy implications	Weakness of the approach	Exemplary works
State-centred approaches: The political institutions view	States	- Politicians decide policy according to institutionally defined rules - Without political institutions that limit government authority governments have strong incentives use the financial system as a source of government finance at the expense of the private sector	Reform political institutions to limit the discretion of public officials	– Link between democracy and economic development not straightforward – Relationship between state and private sector characterised by conflict and interdependence – Dismisses the role of state capacity	Haber et al. 2008; Girma / Shortland 2008; Huang 2010

4.3 Summary: Starting points for an analytical framework to study the potential of activism as a tool to increase finance for private investment in Africa

Existing research on the political economy of finance highlights the need to systematically explore how the interests of different groups translate into financial policy outcomes, in order to weigh the empirical support for activism as a tool to increase finance for private investment in a particular country. The review of the literature highlights two sets of factors as potential determinants of financial policy choices and of the nature of the policy coalitions that shape them, namely

1. *organisational factors*, in particular

- *the autonomy of the private sector (in particular of banks)* vis-à-vis *the government*: The more autonomous the private sector is *vis-à-vis* the government, the higher is the state's structural dependence on it, and the more likely is it that the private sector constitutes a powerful ally in the process of financial policymaking (Bräutigam et al. 2002; Boone 2005). As a result policy coalitions across the public-private divide that seek to reform the financial sector in a way that sustainably increases access to finance are more likely, which plausibly has a positive effect on the design and effectiveness of activist policies.

- *the degree of concentration in the private sector (in particular in the banking sector)*: Concentration in the private sector – whether within the financial sector, among favoured borrowers or as reflected in financial-industrial conglomerates – increases the power of the concentrated segment *vis-à-vis* the government (Haggard et al. 1993). Therefore the political capture of activist policies by powerful economic interests seems more likely in countries where the private (banking) sector is concentrated. Correspondingly it seems plausible that activist policies are more likely to succeed in countries where states are complemented by a diverse and competitive private (banking) sector. A prime example constitutes the case of Chile, where the banking sector has become more diverse and competitive in recent years: There is evidence that private commercial banks, forced to reach out to new customers, tend to support activist policies which help them to serve SMEs and that pro-market activism has become relatively effective (De la Torre et al. 2007; De la Torre et al. 2010). However, in the extreme case of a fragmented private sector, activist policies are less likely to work: Fragmentation constitutes an obstacle to collective action, so that governments would have difficulties to engage with the private sector in policymaking.

2. *the revenue base of the state*. When governments have access to other sources of revenue than domestic bank finance or taxes from domestic private sector activity through *international linkages*, such as credit from international capital markets or, as is more often the case in African countries, aid and exports of natural resources, governments are less structurally dependent on the domestic private sector (Winters 1996, 41; Moore / Schmitz 2008; Maxfield 1990; Boone 2005; Gordon / Li 2009). Thus, in a situation where the degree of reliance on the domestic private sector as a source of

government income and economic prosperity is low, incentives to cooperate with the domestic private (banking) sector to promote business-friendly and activist financial policies are also likely to be low. However the effects of government income from sources other than the domestic private sector are not adverse in all circumstances, because these alternative revenue sources can give governments a degree of autonomy from the domestic private (banking) sector which can also be used wisely. This could particularly be the case if conditions are attached to the use of the external revenues, as in the case of aid or in the context of a strong private sector (Maxfield 1994; Winters 1994; Maxfield 1990).

Future research on the potential of activism as a development strategy could also provide a high added value by considering the role of state capacity: Technical capacity (including adequate organisational and managerial resources) emerges as an important intervening variable in assessing the potential of pro-market activism as a tool to increase access to finance, in particular as pro-market activist strategies often require a commitment to sustainable financial inclusion from multiple actors and effective coordination between them. Technical capacity seems a particularly important factor in the African context: While private sector development has increased the political clout of the private sector in financial policymaking in most African countries, there is a continued variation in the success of ongoing financial reform efforts across countries. Some states reform relatively eagerly, others fail to respond to the pressures from both private bankers to improve the investment climate and from donors and financially excluded businesses to make the financial sector more development-oriented. This suggests that technical capacity is a major mediating factor in explaining and predicting successful activism or policy choice more generally.

Figure 1 summarises the ideas presented in this chapter in an analytical framework indicating key issues in the different arenas of the political economy analysis. Future research could analyse these arenas in the proposed sequence, while it might be useful to revisit, reassess and reinterpret earlier information during the research process.

The framework also takes into account two more general issues: First, that history plays an important role in policy choice through its effect on the organisational structure of the private economy as well as on the financial incentives of various private and public agents. Second, that the state varies, and there are intra-state variations in state capacity.[21]

21 The phenomenon of "pockets of efficiency" illustrates that states vary, and that different state agencies have, different interests and capacities, based on their political and economic support base. There is strong empirical evidence that even in countries with poor governance and weak public sectors, reform-oriented and well-functioning government entities do exist (Leonard 2008). In recent years the Central Bank of Nigeria seems to have emerged as such a pocket: Compared to other developing countries, Nigeria ranks low in governance indicators such as corruption, rule of law or government effectiveness (Kaufmann et al. 2009). Yet, despite a weak overall institutional environment and government capacity, the Central Bank of Nigeria emerged as one of the most eager reformers in sub-Saharan Africa, as indicated by the politically difficult consolidation of the banking sector in 2004/2005, corporate governance reforms in the banking sector in 2006 and 2009 or the ambitious Financial Sector Strategy 2020.

Figure 1: Analytical Framework to study the potential of activism as a development strategy

Arena 1: Defining the financial sector	
Key issues for the analysis	**Selection of guiding questions**
Mapping key players in the sector (e.g. ministries, central bank, bankers' associations)	What are the roles of the different actors in the financial sector? How much influence do different actors have in government and what is the historical basis for the differences?

Arena 2: Basic country analysis	
Key issues for the analysis	**Selection of guiding questions**
Economic structure: economic development, private sector development, revenue base of the state	What is the level of economic and private sector development (including technical skills base, autonomy from government)? What is the organisational structure of the private sector? What are the main sources of government income? To what extent is the government dependent on private sector taxation? How do these structural factors affect the composition and influence of key actors in the financial sector?
Financial sector development	What have been the main policy trajectories within the sector? How have sector roles changed over time, and why? What have been the consequences for policymaking and implementation?
Government capacity	Does government exercise authority over bureaucracy, military, raising public revenue and policymaking?
Development of (political) institutions	How well institutionalised are the government apparatus, policymaking processes and political parties?

Arena 3: Analysis of key organisational players in the financial sector	
Key issues for the analysis	**Selection of guiding questions**
Roles and mandates	Official and unofficial roles and mandate of the organisation
Organisational structure	Structure; balance of power across the organisation
Management and leadership	Key actors; degree to which power is vested in individuals
Financing	Financial balance; sustainability of budget; degree of self-financing; effect of funding source on policy preferences
Incentives and motivation	Opportunities for career advancement; level and distribution of remuneration; benefits and losses from changes of incentives
Capacity	Skills and resources; adequacy of information base; power of the organisation to define and implement policy
How do historical legacies affect: roles, mandates; organisational structure; management, leadership; financing; incentives and motivation; capacity	

Arena 4: Key issues for the analysis of the relationship between key players
Historical foundation of relationships; power balance in relationships; how and why relationships have changed over time; effect of alliances on policy preferences and policy processes; impediments to and niches for collaboration across organisations and the public-private divide

Source: Adapted from Moncrieffe / Luttrell (2005) and Moore (2001)

While it should not be seen as an inventory, this preliminary framework offers some starting points for thinking about which elements might be important to consider in an analysis of the potential of activism as a tool to increase finance for development in a particular country. The framework could also more generally inform research which seeks to explore the political economy in developing countries, faced with the task of governing finance in a way that supports national development and, at the same time, to respond to pressures from international markets to limit the role of the state in financial markets.

4.4 Implications of the approach

Supporting an activist strategy, that is deliberate government interventions in the financial sector to promote the outreach of financial services to segments of the private sector which have been underserved, requires an understanding of the political environment, particularly of the financial interests and of the political clout of key actors. If the political conditions suggest that government entities have good enough governance to pursue activist policies effectively then there are, in line with welfare economic theory, convincing arguments for development practitioners to support well designed, time-bound activist policies to complement modernist approaches.

But what if the political economy analysis suggests that the preconditions are not in place and governments are not likely to pursue activist policies successfully? The political economy framework drawn up in the last chapter emphasises that policy choices are at least to some extent outcomes of the historical development path of a country. These historical foundations do not lend themselves to simple policy proposals because they suggest that there is some element of path-dependency in policymaking. However, taking the political economy framework as a starting point it is possible to propose strategies for economic change in the short and longer term, and to also draw policy implications for African countries with a political environment unfavourable to activism. The political economy perspective suggests that policymakers and advisors in these countries seeking to promote access to finance need to pursue alternative strategies. In countries where activism is unlikely to work effectively, there are two main strategies to align the interests and incentives of the political and economic elites with those of the wider society: The first is to change the power balance in society to expand the space for reform policies, the second is to work within this power balance.

4.4.1 Changing the power relationships within society

If the political economy analysis suggests that the political environment is not favourable to effective activist policymaking, then one of the two main options is to implement policies that focus on changing the balance of power in society in a direction that is more conducive to inclusive financial systems. Such a strategy is clearly a complex, mid- to long-term and politically sensitive task. However, some donors, in concert with reform-oriented domestic constituencies and eventually the diaspora, are already implementing strategies for strengthening the political power of those groups with an interest in a greater and more

sustainable outreach of financial services, such as SMEs or social entrepreneurs providing financial services, and there have been important achievements in this respect.

There is a large body of work (Wittman 1989; Przeworski 2000), which argues that one potential way to change the power balance within society, is to change the political institutions and to try to induce greater political competition as this would stimulate more socially efficient policies. This is also in line with the political institutions view of financial sector development, which explains the cross-country variation in financial development by variation in the degree of access to political institutions (Haber et al. 2008). However, as outlined in previous chapters, democracy has been a poor predictor for successful activism in the developing world. Political power to influence financial policymaking seems to derive less from the formal institution of electoral democracy, but rather from the control over economic resources and the ability of a group to organise itself into a political force.

This suggests that public development strategies in these countries should have two major goals: Supporting those with an interest in inclusive and sustainable financial systems, such as small manufacturers, farmers or even banks seeking to reach out to SMEs, to gain economic weight and help them to organise themselves along interest lines. Middle and lower income groups as well as smaller entrepreneurs are often fragmented, because they lack the resources to organise themselves into a viable political force. For this reason, policies to strengthen political organisation should focus on encouraging what political economists call political entrepreneurship. A political entrepreneur, which could be an individual, such as a reform-oriented minister, or an organisation, such as a manufacturers association, a political party or, under certain conditions, even a venture capital fund, helps those who lack resources and have difficulties in forming a group to organise themselves into a political force. Political entrepreneurs do so through collecting and disseminating information, subsidising the costs of organisation and thereby facilitating collective action (Noll 1989; Kosack 2009). In many poor African countries, donors are the single most important political entrepreneurs: Through financial and technical assistance, they seek to strengthen the political and technical capacity of business membership organisations or of financial institutions targeting the lower end of the spectrum, such as microfinance banks. This contributes to improving the enabling environment for government-private sector relations. In the long term these efforts might strengthen the consumers of financial services, financial service providers interested in serving SMEs and public entities which promote access to finance, thus making the financial system more diverse and inclusive. As long as the private sector does not constitute a partner and challenger to the state, governments are unlikely to be responsive to the needs of those affected by their policies (Bräutigam et al. 2002).

While there are many examples where political entrepreneurship had positive effects, it is less clear how to encourage it on the ground. It will be up to further research to shed more light on this issue. Although democracy is not a sufficient precondition for group formation, democracy may be helpful to encourage political entrepreneurship, as certain aspects of it make political entrepreneurship easier, such as freedom of both speech and association.

4.4.2 Working within the existing power relationships of society

An alternative to shifting the political power relationships would be to try to work within them. The challenge here is to design policies which have the potential to increase access to finance for productive investment in weak institutional environments, but are also incentive-compatible for those with economic and political power.

In some parts of the financial development debate today, modernist policies are regarded as the preferred solution for reforming financial systems in societies where the political environment suggests that activist policies are unlikely to succeed. Seeing only a limited role for governments in financial markets, this approach posits that governments should focus on policies strengthening macroeconomic stability and the market-based provision of financial services through large-scale finance: Ensuring that banks can safely lend on financial resources, enabling companies in the formal sector to find the mix of equity and debt finance they need to grow, as well as implementing sophisticated tools for risk management, rank high on the agenda of modernists (Honohan / Beck 2007, 9). The guiding principle is to imitate the best practices of the advanced economies in developing countries.

However, past experience demonstrates that the potential for building inclusive financial systems by solely following the modernist approach is limited. In Botswana, for instance, which has primarily followed a modernist approach since independence, there still are large gaps in access to finance for the middle market, lower income groups, agriculture and industries depending on long-term finance (Jefferis 2007; Harvey 1998; Boone, 2005). The experience in other sub-Saharan African countries is similar and the increase in outreach during the modernist period has also fallen short of expectations (Beck et al. 2009; Nissanke 2001): African financial markets have remained highly fragmented with little effective linkages and competition between market segments so that the majority of the population is still outside the formal banking system, served only by microfinance institutions or informal arrangements.

Moreover, there is empirical evidence that a modernist approach also raises political economy problems and that inadequate governance structures can undermine modernist policies, as indicated by the problems of political capture in privatisation processes or revisions of capital adequacy requirements (Haggard / Lee 1993, 13-15; Brownbridge et al. 1998; Lewis / Stein 1997).

For these reasons, it is now widely acknowledged that it is even in countries with an unfavourable political environment necessary to complement modernist approaches with deliberate interventions to broaden access to finance, although the focus might shift away from government-led solutions (Honohan / Beck 2007, see in particular pages 7-12). Such interventions could be designed by groups which are removed from internal political pressure, e.g. donors or regional institutions, such as regional development banks.

However, what are the options for African policymakers trying to work within unfavourable political environments?

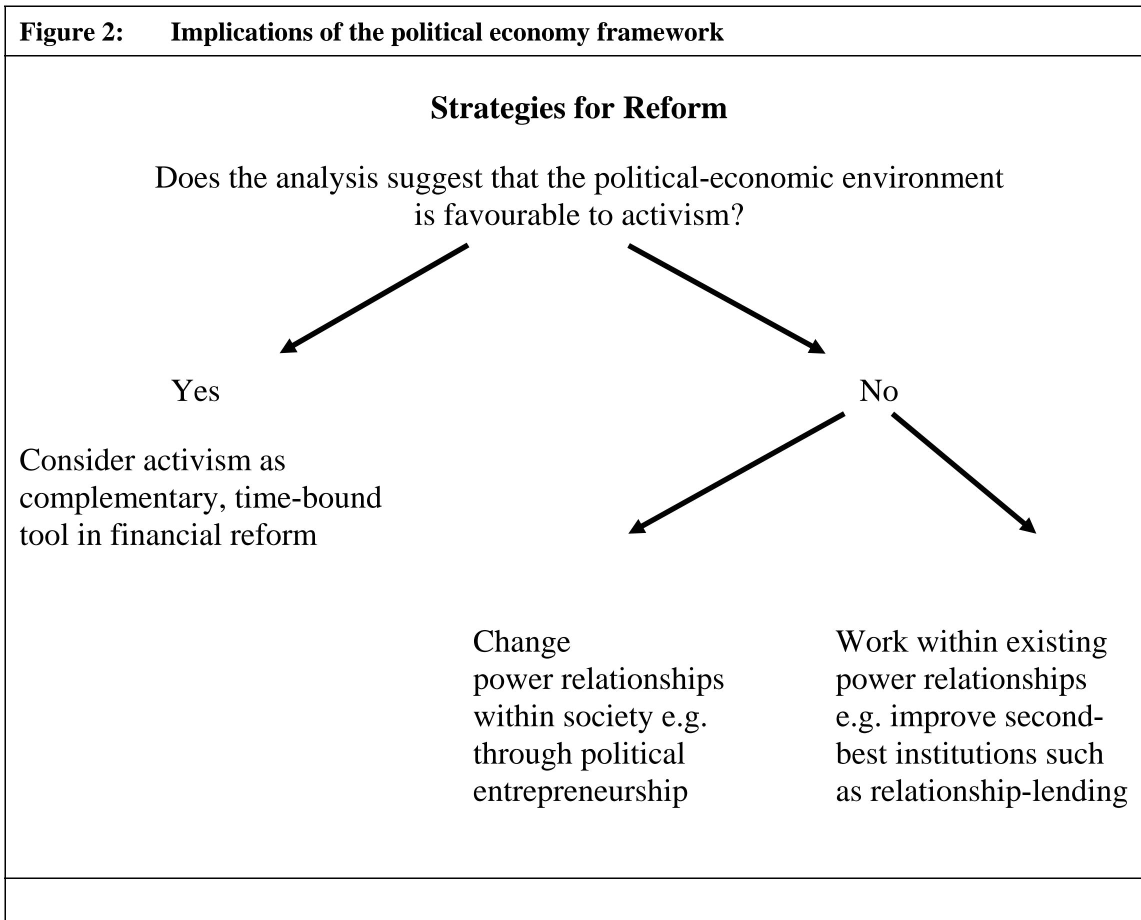
- First, they could try to find ways of supporting the activist agenda of non-state actors, such as social entrepreneurs, which are incentive-compatible for those actors in power.

- Second, it follows from the political economy analysis that policymakers and development practitioners should create a stable revenue base: It seems plausible that governments in fiscal crisis, lacking stable sources of revenue to finance public expenditure are less likely to govern the financial sector in a way that contributes to broad-based private investment, given the incentive to use the financial sector as a source of finance for government.

- Third, and more generally, policymakers should incorporate the insights from research that policies which not only target the poorest and least powerful groups, but also include the middle-market, are more likely to succeed: Defining a broad access agenda that includes middle-sized enterprises that also lack access to investment resources, helps to mobilise powerful supporters (Rajan 2006).

- Finally, more recent research on the political economy of reform suggests that improving existing or even establishing new second-best institutions could be a promising way forward in countries with an unfavourable political environment (Rodrik 2008). This body of literature challenges the notion that all developing countries should focus on building up the best-practice (or first-best) institutions prevailing in rich countries, such as efficient courts, private property rights or bankruptcy laws. The key assumption is that the kind of institutions reformers should build should be contingent on the economic constraints and political realities of a specific country at a particular stage of development (Gerschenkron 1962; Rodrik 2008; Adler et al. 2009). Given that developing countries face different constraints and different political environments than rich countries, this may require the adoption of more fitting second-best institutions, which differ from those prevailing in rich countries, as a transitional device. Second-best institutions might offer a more pragmatic way forward, because they fit better with the economic and political realities in developing countries in the short term. In light of the difficulties African states face in implementing best-practice institutions, exploring the potential of second-best institutions such as relationship-lending, as opposed to rules-based lending, seems highly policy-relevant (Biggs / Shah 2006). Given the potential social costs of the provision of credit within exclusive, relationship-based credit networks, it remains an important question for researchers under what conditions second-best institutions can help building more inclusive financial systems in sub-Saharan Africa.

Figure 2: Implications of the political economy framework



5 Conclusion

There is strong empirical evidence that access to finance for private investment is essential for enterprise development and economic growth. However, financial systems in sub-Saharan Africa have remained highly exclusive. This is primarily the result of market failures which make the provision of financial services to lower income groups and SMEs prohibitively costly or, due to an uncompetitive market environment, unattractive. While market failures provide an argument for activism (defined as deliberate government interventions to promote access to finance), the experience with activism has been mixed at best. However, even though activism does not guarantee an increase in broad-based productive private investment, past experience, both in the developing and the developed world, suggests that achieving this goal without deliberate government interventions is difficult, if not impossible.[22] For this reason there is a renewed interest among development practitioners in the question, under what conditions activist government interventions in financial markets could serve as a tool to increase access to finance for productive investments.

It is now commonly acknowledged that the effectiveness of activism depends on politics and there is a consensus that good governance is a precondition for government interventions to be successful. This paper argues that while the current consensus on the potential of activism is a promising way forward, its policy implications are not quite clear: There is no fully developed positive approach of government activism and thus no framework which helps evaluating *ex ante*, whether a government entity is likely to successfully assume an activist role. Without such *ex ante* predictors development practitioners will find it difficult to prioritise reform policies and define the adequate role for government in a particular country, ranging from a modernist to a pro-market activist role. Moreover, without such a framework there is the risk of spending resources on policies that seek to increase financial access, which are not likely to succeed and are unsustainable, spreading disenchantment with aid and leaving African countries without the financial services they urgently need.

This paper shows that political economy can provide a framework which helps to assess whether government interventions in a particular country have a chance to succeed: Through the focus on endogenous policy choices, political economy allows to study any policy as the outcome of a political decision making process. Thereby political economy does not only help to predict the chances of success of an activist approach, but also to draw policy implications for those countries which are currently not likely to have good enough governance to successfully pursue activist policies.

The existing literature on the political economy of finance suggests that the assumption of interdependencies between private and public agents should frame the political economy analysis. Existing work also shows the value of an approach which seeks to explain or predict financial policy choices through the analysis of coalitions of interests between private and public agents. Thereby the nature of a particular policy coalition and its power to

22 For a more general discussion of this argument with respect to agriculture, see Chang (2000).

determine financial policies seems to be particularly shaped by the historically produced organisation of the private banking sector *vis-à-vis* the state, and the revenue base of the state.

If the political economy analysis suggests that the political conditions are favourable, there are convincing arguments for supporting well designed activist policies such as subsidies or tax incentives as temporary devices to complement modernist approaches. More often than not, the political environment is likely to be unfavourable, so that governments must pursue strategies other than activism to encourage economic development. Political economy suggests two main strategies for advisors and policymakers in countries with an unfavourable environment: One possibility is to try to change the power relationships within society, for instance through encouraging political entrepreneurship to empower financially excluded groups. The alternative is to work within the political environment and for example improve the functioning of second-best institutions, such as relationship-lending.

These arguments entail a new thinking on how to decide about spending resources to build inclusive financial systems by emphasising the need to focus on what drives development and what is politically feasible. Taking such a pragmatic, but maybe more realistic, approach requires greater openness for second-best policies: While globally deemed first-best solutions such as property rights and efficient courts, are crucial for financial development, they might be difficult and slow to establish in countries with an unfavourable political environment. In such countries a focus on the low-hanging fruit, such as fostering relationship-lending schemes or social entrepreneurship might offer limited progress, but also a more promising way forward, because through their effect on the political environment, second-best policies could increase the demand for first-best policies in the longer term.

Translating both implications – to revise financial reform strategies in accordance with the results of political economy analysis and to be open to time-bound second-best (including activist) solutions – into policy is not straightforward: There is very little research to build on that uses a political approach to explore issues of financial reform, and much of it lacks operational relevance for the African context. Political economy has not yet received serious attention in the policy debate on financial reform, in spite of the rhetoric that it is necessary to go beyond the technicalities, and address questions of political feasibility. Robinson (2009, 9) has received much support in policy circles for more generally pointing out that "the problem of underdevelopment cannot be solved by economists coming up with better policies for poor countries to adopt or endlessly hoping for benevolent 'leadership'." It is time to take up the challenge and analyse more systematically how to propose financial policies in a way that they are chosen endogenously, and supported by those with political and economic power.

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