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Ozili, Peterson K

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Fault Lines in Financial Inclusion

Peterson K. Ozili

Abstract

Financial inclusion has been a global development policy priority over the last two decades. Financial inclusion involves providing access to basic financial services and the use of basic financial services to improve the welfare of individuals, households, and businesses. This article identifies the fault lines or vulnerabilities in the way financial inclusion is achieved. These fault lines or vulnerabilities arise from the over-reliance on profit-oriented financial institutions to achieve financial inclusion, the multiple self-interest in the financial inclusion agenda, the unsustainability of policy-induced demand for basic financial services, the lack of safety net to protect poor banked adults from systemic risk events, and the prevalence of financial inclusion-washing that allow agents to misrepresent their support for financial inclusion. The article argued that the world needs to pay serious attention to these fault lines and seek solutions that promote financial inclusion in a sustainable way. The ideas in this article can help policymakers, academics, practitioners, and researchers in assessing the fault lines created by financial inclusion policies and strategies as this is the first step to finding solutions to address the fault lines.

Keywords

Access to finance - banked adults - fault lines - financial inclusion - financial institutions - formal account.

Orcid: 0000-0001-6292-1161
JEL codes: G21, G28.

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1 Introduction

In this article, I point out the fault lines or vulnerabilities in the way financial inclusion is achieved. Existing studies in the literature have not examined how the vulnerabilities in the financial system create problems that undermine the expected benefits of financial inclusion for society. The current benefits we enjoy from successful financial inclusion strategies and policies can be likened to the massive profits gained by bankers and speculators during the 2005–2006 derivatives bubble prior to the 2008 global financial crisis. Regulators were excited about the positive economic effect of the derivatives for job creation and gross domestic product while ignoring the vulnerabilities that were created, which was essentially 'over-leveraging' at the time. Soon the bubble burst and everyone blamed Wall Street and greedy bankers. As a result, regulators were blamed for the 2008 global financial crisis. But the lesson learnt was that there is a tendency to downplay risks and vulnerabilities in the midst of massive profits.

Similarly, in the midst of much gains from financial inclusion, policy makers are focusing on how to further increase the gains from financial inclusion while academic researchers are increasing their research about the impact of financial inclusion on the economy. Yet, there is little or no discussion in the literature about the vulnerabilities or fault lines created by the policies used to achieve financial inclusion. The reason for the scant discussion is because many financial inclusion studies are fixated on positive-evidence gathering and in developing indices to measure financial inclusion instead of exposing the vulnerabilities that underlie the recent financial inclusion agenda. There is a need to identify the fault lines or vulnerabilities created by financial inclusion policies and strategies so that some consensus can be reached on how to address them before they lead to unexpected outcomes.

This study contributes to the literature in the following ways. Firstly, the discussion contributes to the financial inclusion literature by identifying the issues that need to be addressed to achieve higher levels of financial inclusion. Secondly, the study contributes to the academic studies that analyze the challenges of financial inclusion (e.g., Collard 2007; Dev 2006; Ozili 2021a, 2021b, 2021c; Varghese and Viswanathan 2018). This study contributes to these studies by focusing on the fault lines or vulnerabilities that can undermine the benefits gained from financial inclusion.

The rest of the study is structured as follows. Section 2 presents the literature review. Section 3 presents a discussion about the fault lines in financial inclusion. Section 4 presents the conclusion.

2 Literature Review

Financial inclusion is important because it is a necessary condition for sustaining equitable growth (Dev 2006; Kim et al. 2018; Mohan 2006). Financial inclusion can increase access to credit, savings and investment products, which individuals, households and businesses can use to improve their welfare (Chen and Jin 2017; Demirgüç-Kunt and Klapper 2013; Mehrotra and Yetman 2015; Ozili 2021d). Empirical studies find a positive association between financial inclusion, socioeconomic prosperity, and economic development. For instance, Neaime and Gaysset (2018) examine whether financial inclusion mitigates poverty and leads to a reduction in income inequality. They use the Generalized Method of Moments (GMM) and Generalized Least Squares (GLS) econometric models to estimate the impact of financial inclusion on poverty and income inequality. They analyzed eight Middle East and Northern African (MENA) countries from 2002 to 2015, and find that financial inclusion decreases income inequality while financial inclusion has no direct effect on poverty. Similarly, Park and Mercado, Jr. (2015) examine the impact of financial inclusion on poverty and income inequality. They analyze 176 countries including 37 countries from the developing Asia region. They find that an increase in financial inclusion is significantly correlated with low poverty and income inequality levels; but there is no link between financial inclusion and income inequality for countries in developing Asia.

Also, Omar and Inaba (2020) investigate the impact of financial inclusion on poverty reduction and income inequality for 116 developing countries from 2004 to 2016. They find that financial inclusion significantly reduces poverty rates and income inequality in developing countries. The implication of the findings is that promoting access to, and usage of, formal financial services can maximize society's overall welfare. Matekenya et al. (2021) investigate the effect of financial inclusion on human development in Sub-Saharan Africa. They argue that access to, and usage of, financial services may encourage business start-ups, and allow individuals to invest in health and education, and therefore, lead to improvement in human development. They analyze African countries from 2004 to 2017. Their results show that financial inclusion has a positive effect on human development. Ozili (2020), in a cross-country study, investigates the association between social inclusion and financial inclusion. The result reveals a positive correlation between social inclusion and formal account ownership in European and Asian economies while there is a negative correlation between social inclusion and formal account ownership in African countries and Middle Eastern countries.

Other studies show that financial inclusion leads to an improvement in financial system stability. For instance, Ahamed and Mallick (2019) investigate whether greater financial inclusion is good for bank stability. They analyze 2,913 banks and construct a composite index of financial inclusion for 87 countries from 2004 to 2012. They find that higher levels of financial inclusion lead to greater bank stability, and the effect is more pronounced when banks have higher market power and operate in countries where political stability, rule of law, and regulatory environment are stronger. The implication of their result is that financial inclusion not only fosters development, it also contributes to bank stability. Pham and Doan (2020) investigate whether financial inclusion contributes to financial stability. They use a proxy to measure financial inclusion, which is the number of SME borrowers to total borrowers, and the ratio of outstanding SME loans to total loans divided by Z-score. They find that the financial inclusion proxy variables have a significant and positive effect on financial stability.

Danisman and Tarazi (2020) investigate how financial inclusion affects the stability of the European banking system. They find that advancements in financial inclusion through more account ownership and digital payments have a stabilizing effect on the banking industry. The stabilizing impact is driven by the targeting of disadvantaged adults who are young, undereducated, unemployed, and who live in rural areas. Ozili and Adamu (2021) examine whether countries that have high levels of financial inclusion have fewer nonperforming loans and loan loss provisions. They analyze the banking sector of 48 countries and find that greater formal account ownership is associated with high non-performing loans. They also find that bank loan loss provisions are fewer in countries that have high levels of financial inclusion only when financial inclusion is achieved through the combined use of formal account ownership, bank branch supply, and ATM supply.

Other studies identify some challenges to achieving financial inclusion such as the need to resolve technology issues when digital channels are used to promote financial inclusion (Khan 2020; Ozili 2018), the social divide and social inequalities that affect developing and emerging countries (Milana and Ashta 2020), the low usage of banking services, debit cards, credit cards, and bank-borrowing in poor countries (Mani 2016), gender bias (Botric and Broz 2017; Mani 2016), illiteracy, and poor infrastructure such as poor internet connectivity (Ali 2017).

While existing studies have examined the benefits and challenges of financial inclusion, they have not explored issues that threaten the financial inclusion agenda. I call these issues "fault lines" in the financial inclusion agenda and explore some of these issues in the next section.

3 The Fault Lines

3.1 Over-reliance on profit-oriented financial institutions to achieve financial inclusion objectives

The most obvious fault line or vulnerability is the over-reliance on profit-oriented financial institutions to achieve financial inclusion objectives. Many of the financial inclusion strategies adopted in many countries are structured or designed to make financial institutions the main agent that provide access to cheap credit, high-interest savings, and investment products. Also, the technology that enable the delivery of financial services through digital channels are equally designed to interface with financial institutions before reaching end users or banked customers. All agents of financial inclusion, including agent networks, are connected to profit-oriented financial institutions in one way or the other. Agent networks are either promoted by formal financial institutions or they finalize their financial transactions through the gateway provided by financial institutions. As financial institutions continue to play a lead role in expanding financial services for financial inclusion, dependencies on financial institutions will increase. These dependencies make financial institutions become too powerful. Policy makers, knowing that financial institutions are very risky and that trust in banks can disappear very quickly especially during bad times, still entrust financial institutions with the responsibility to promote financial inclusion, and they give financial institutions specific financial inclusion targets to meet. While this structure has worked well for many years and continues to yield the results that policy makers want to see, there seem to be a lack of concern that the financial inclusion agenda is achieved through a monopolistic structure centered around profit-oriented financial institutions and there is no significant alternative to replace them in the financial inclusion agenda.

Technology companies may not be a very helpful alternative because they do not have legal rights to access customers' financial information or customers' bank account information for financial inclusion purposes. In fact, technology companies must partner with profit-oriented financial institutions to gain access to customers' information. Also, peer-to-peer (P2P) financial services is not a perfect alternative because the P2P segment of the financial system is not well developed in many countries. Moreover, banked customers using P2P financial services may need an intermediary they can run to, to help them reverse payments made in error over a P2P platform such as the blockchain. This means that P2P financial services may not fully eliminate third-party intermediation, and the intermediary that will be created to offer blockchain-customer support services will most likely be a profit-oriented financial institution. This clearly shows that technology companies and P2P financial services are not a reliable alternative because they also rely on profit-oriented financial institutions to achieve high levels of financial inclusion.

The absence of a real alternative can put everyone in deeper financial turmoil when financial institutions begin to fail.[1] Recent historical events remind us that large (or systemic) financial institutions can fail, and when they fail, they can take down other financial institutions connected to them. The implication is that the achievements made towards financial inclusion can disappear when financial institutions collapse, especially financial institutions that are involved in a significant financial inclusion activity. This calls for careful watch by financial regulators and supervisors. They need to rethink financial stability and understand the interlinkages between financial stability and financial inclusion. They should ensure that financial crisis do not happen. They should monitor financial institutions very closely to identify early warning signals of financial distress in the financial sector and intervene quickly to resolve such issues.

3.2 Multiple self-interests

Some development academics or scholars believe that financial inclusion will solve the world's poverty problem, and they are vocal about it. Other development academics see financial inclusion as an inadequate but politically palatable alternative to redistribution of wealth. They believe that the success of financial inclusion depends on how it is administered. In fact, some scholars believe that financial inclusion leads to increased indebtedness among the poor. Despite the negative sentiments about the financial inclusion agenda, there are many supporters of the financial inclusion agenda, and these supporters have multiple interest in the financial inclusion agenda.

For instance, many academics are interested in the financial inclusion agenda because they believe that financial inclusion will uplift poor people from poverty, and give poor people alternative ways to access finance, which they can use to improve their welfare. Academics also conduct research in the area of financial inclusion hoping to find some relationship or correlation between greater financial inclusion and better socio-economic outcomes for poor people.

The second interest group are practitioners, such as banks, non-bank financial institutions, and technology companies, who are interested in the financial inclusion agenda because they want to generate fee income through transaction cost. The third interest group are not-for-profit organizations who are interested in the financial inclusion agenda and they are vocal about it. They are interested because they want to show that they have the interest of poor people (or unbanked adults) at heart, and are willing to do what they can to support a public sector- or private sector-led financial inclusion initiative that is pro-poor by design, and as long as the financial inclusion initiative fits well with the organization's mission.

The fourth interest group is the government. Governments or policy makers are interested in the financial inclusion agenda not because they want poor people to become rich through financial inclusion tools, but rather because of the numerous benefits that high levels of financial inclusion would bring to the economy, such as more tax revenue from banked adults, curbing illegal activities in the informal financial sector, better management of monetary policy, and control of inflation.

The fifth interest group includes international development organizations and aid agencies, such as the USAID and the World Bank. These organizations support the financial inclusion agenda because it has broad political support in the West and it increases their reputation as promoters of development in developing and poor countries.

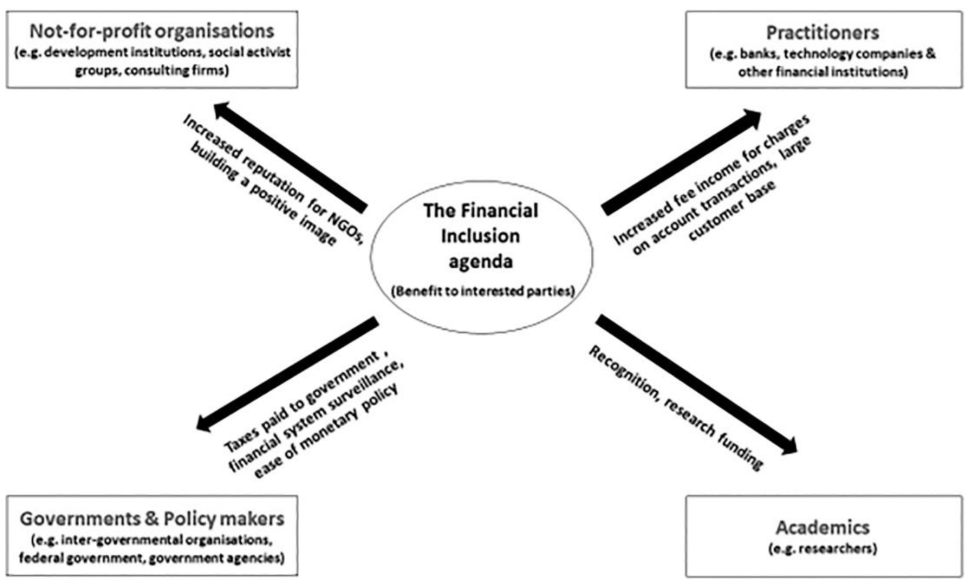
The last interest group are borrowers who often support financial inclusion programs that give them easy access to credit, low interest loans, and financial security.

[1] Even if financial institutions are not failing, the high interest rates charged on loans by financial institutions often erode the profit of small businesses and even drive some borrowers deeper into poverty.

Figure 1 shows some of the self-interest that agents, promoters, or supporters of financial inclusion hope to gain from promoting or supporting the financial inclusion agenda. For instance, academics could receive generous research grants or funding from research agencies to conduct financial inclusion research. Practitioners expect to receive substantial fee income and high profits when financial inclusion programs are promoted through banks and technology companies, while governments and policy makers want to generate more tax revenue from the banked population. Not-for-profit organizations, or non-governmental organizations (NGOs) want to increase their reputation when they support on-going financial inclusion programs, policies or activities.

With these parties having some self-interest in the financial inclusion agenda, it is very hard to see how financial inclusion programs and schemes will benefit poor and excluded adults more than it benefits the agents, promoters, and supporters involved in the financial inclusion agenda.

Figure 1 Benefits from promoting or supporting the financial inclusion agenda



3.3 Financial inclusion-washing – misrepresenting support for financial inclusion

Financial inclusion-washing is a phenomenon where people, organizations, or governments label themselves as promoters or supporters of financial inclusion by using buzzwords like 'reaching the unbanked,' 'finance for all,' 'finance that leaves no one behind,' or 'finance everywhere you go,' but they do not make any real effort to increase the level of financial inclusion in a meaningful way. Financial inclusion-washing can also occur when individuals, organizations, or government agencies spend more time and money in marketing themselves as supporters or promoters of financial inclusion without making any significant effort to reach the unbanked population. Some motivation for engaging in financial inclusion-washing include (i) the desire to increase one's reputation in the public space; (ii) the need to capitalize on the growing demand for accessible and affordable financial products and services; and (iii) the need to show that an organization or agency is pro-poor in its orientation.

The practice of financial inclusion-washing has been going on for a long time without any effort to curb it through regulatory actions. This practice taints the authenticity of the financial inclusion agenda, and it is a serious fault line in the financial inclusion agenda. Governments engage in financial inclusion-washing when they overstate their capacity to achieve specific financial inclusion targets. For example, a government might make an announcement that it plans to increase the level of financial inclusion from 35 percent to 80 percent by 2030 without explaining in specific terms how it intends to achieve that target. Organizations engage in financial inclusion-washing when they claim that their technology, activity, product, or service can increase the level of financial inclusion from 15 percent to 75 percent without explaining how it will be achieved. This practice is unethical and can mislead customers into believing that the technology, activity, product, or service offered by a firm can promote financial inclusion when it does not.

The three main ways through which individuals, corporations or agencies engage in financial inclusion-washing are through (i) advertising; (ii) labeling; and (iii) public relations. With regards to advertising, this is the most common form of financial inclusion-washing because it promotes selective misinformation. It involves advertising specific financial-inclusion buzzwords on websites and on mobile applications. Individuals, corporations, or agencies advertise these buzzwords on their websites or in advertising materials while hiding other aspects that may be detrimental, such as the hidden fees and high transaction cost associated with the services in financial inclusion schemes. Consumers may be misled into using a financial product or service they think promotes financial inclusion but only does so marginally. With regards to labeling, there is growing demand for financial-inclusion labels such as certifications. Financial-inclusion certifications have saturated the market. Companies are looking for so-called ‘certified’ labels that will give them recognition in the financial-inclusion space and increase their environment, social, and governance (ESG) rating in the community or country where they operate. Some financial-inclusion labels may look official while others may be self-declaratory. With regards to public relations, financial inclusion-washing can occur in a variety of ways. For instance, an organization can persuade or lobby a group of people to embrace financial-inclusion messages while simultaneously lobbying to be the agent that delivers financial products and services to the same group of people. Also, there may be deliberate attempts to change public opinion in favor of financial inclusion. Furthermore, a group of independent and reputable people, such as economists, celebrities, and activists, may be offered large amounts of money in return for their endorsement of specific financial-inclusion messages, products, or services. Also, financial institutions who are lobbyists may work with the government to deliver financial-inclusion projects, but may be unwilling to lower their price to a price that is affordable to poor bank customers. Financial inclusion-washing does more harm than good because nobody likes to be deceived into believing that an individual, organization, or government is doing something that it is not doing. Individuals, organizations, or government agencies use financial-inclusion buzzwords like ‘reaching the unbanked,’ ‘finance for all,’ ‘finance that leaves no one behind,’ and ‘finance everywhere you go’. They use these types of buzzwords without explaining how they plan to achieve it. Failing to provide information about how they plan to reach that status constitutes financial inclusion-washing because they can stop pursuing the proposed financial-inclusion goal at any time and will not be held accountable by anyone. Financial inclusion-washing is currently not illegal, although its consequences may be detrimental because it misleads people. To prevent financial inclusion-washing, policy makers should issue policies and directives that prevent the spread of misleading information about an organization’s or government’s capacity to achieve specific financial-inclusion targets.

3.4 Lack of safety net to protect poor banked customers from systemic risk events in the financial sector

There is the risk that systemic risk events, such as financial crises, can become very severe in countries that have attained full financial inclusion or the highest level of financial inclusion. This is because high levels of financial inclusion will bring more poor people into the formal financial sector. The consequence is that financial crises will have a devastating effect on poor banked households and small businesses than ever before. Prior to the 2007–2009 global financial crisis, many households in developing economies were unaffected by the global financial crisis because many households did not own a formal bank account in too-big-to-fail banks, and therefore, had less exposure to the international banking system, which almost collapsed in 2008. Today, the on-going campaign to achieve high levels of financial inclusion particularly in developing and poor countries means that a large number of people will be brought into the formal financial sector, they will be connected to the international banking system through their local bank, and consequently, a collapse of any segment of the international banking system could trigger a run on banks and could have ripple effects on the local banking system thereby affecting poor individuals and poor households in unprecedented ways.

Currently, policy makers have not found a way to ring-fence poor bank customers from being affected by a banking crisis or financial crisis. Poor banked customers are likely to suffer the most from a banking crisis because, even though they have small account balances, they do not have enough money to hire the services of a competent financial advisor who can advise them or warn them about an impending financial crisis and advise them to remove their money from about-to-fail financial institutions just before a financial crisis starts. Meanwhile, richer bank customers have such privileges through their high net worth, their connection with bank managers, and their ability to hire the services of financial advisors.

Since policy makers are aware that bringing poor people into the banking sector will expose them to systemic risk, policy makers need to take steps to ensure that financial crises do not occur. They must intervene to rescue failing banks. They should give regulatory forbearance to reduce regulatory burden on weak banks, and if possible, find a way to ring-fence the deposit of poor banked customers from other deposit, so that poor banked customers do not lose their money during unfavorable systemic risk events in the financial sector.

If policy makers do not find ways to protect poor banked customers from losses arising from systemic risk events, such as financial crises, these customers may lose confidence in the financial system, and will have strong incentives to exit the formal financial sector, preferring to return to the informal financial sector. In a nutshell, the inability to protect or shield poor customers from systemic risk events in the formal financial sector is a fault line in the way financial inclusion is being achieved.

3.5 Policy-induced demand for financial services is not sustainable

The frequent use of policy to induce demand for basic formal financial services is another vulnerability in the way financial inclusion is achieved. This practice is common especially in developing countries and in countries where the forces of demand and supply do not freely determine the price of basic financial products and services. Introducing policies to increase demand for basic financial services will undoubtedly increase financial inclusion in the short term because it can lead to cheaper financial services and low transaction cost. But when the policies are discontinued or withdrawn, the market for those services will reset and lead to externalities.

Let's take an example to illustrate this point. Assume a government introduces a policy that allows free digital transfers on all person-to-person transfers and person-to-business transfers in the financial system in order to encourage the use of digital channels for financial intermediation such as mobile banking applications, digital wallets, and internet banking. After introducing the policy, the policy led to a significant increase in the demand for digital financial services. People began to use digital channels to pay salaries, utilities, internet subscriptions, and many more. The number of people using digital channels, and the volume of digital financial transactions, increased by over 80 percent. After a while, financial institutions will begin to lobby the government to impose transaction fees on each digital financial transaction. Financial institutions may claim that they cannot bear the high cost of maintaining the underlying technological infrastructure that is used to facilitate digital financial transactions. Financial institutions want the government to impose a transaction cost for each digital transfer to help them cover the cost of using the technological infrastructure. The government will approve the imposition of a transaction cost of $5 per digital transfer. Soon after the announcement of this transaction cost, the market for basic financial services will begin to reset gradually to its previous state when people become aware that they are being charged $5 for each financial transaction on a digital channel. People seeking to avoid the transaction cost will stop using digital channels and revert back to the old way of making financial transfers. Over time, this will lead to a significant decline in the volume of digital financial transfers. The point here is that the government had earlier introduced a free digital financial transfer policy, which increased digital financial transfers, and later reversed the decision by approving the imposition of a transaction cost at the request of financial institutions, which led to a decline in the demand for digital financial transfers.

Using policy to induce demand for financial products and services can be helpful sometimes. It can increase demand at a time when demand is extraordinarily low. But the problem with policy-induced demand is that policy makers may discontinue policies too early or too late since it can be difficult to know the right time to discontinue policies that have been introduced. The consequence of discontinuing imposed policies too early or too late is that it can make markets adjust or reset to a dis-equilibrium level. To address this issue, policy makers should allow the demand for basic financial services to grow naturally. Policy makers should resist the urge to use policies to induce the demand for basic financial services. This will help to avoid market reset that comes with painful consequences for households and other economic agents.

4 Concluding Remarks

This article identified and discussed the fault lines or vulnerabilities in the way financial inclusion is achieved. The fault lines or vulnerabilities are the over-reliance on profit-oriented financial institutions to achieve financial inclusion, the multiple self-interest in the financial inclusion agenda, the unsustainability of policy-induced demand for basic financial services, a lack of safety net to protect poor banked adults from systemic risk events, and the prevalence of financial inclusion-washing that enables agents to misrepresent support for financial inclusion.

All in all, the tendency for poor banked customers to suffer the most from systemic risk events, such as a pandemic, financial crisis, or economic crisis, suggests that there are structural fault lines in the way financial inclusion is achieved. While these fault lines still persist, it is possible that these vulnerabilities can amplify fractures and inequality in the financial system, leading to loss of welfare for poorer banked customers. Looking forward, policy makers need to develop solutions to address these fault lines.

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