



Making Finance Work for Africa



PATRICK HONOHAN and
THORSTEN BECK



THE WORLD BANK

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Foreword

All across Africa, access to finance is rightly seen as the key to unlocking growth for poor farm families as much as for expanding export firms. This book explains that Africa needs not only funds, but also a more effective and inclusive means of channeling funds and other financial services to where they can be most effective.

Making financial systems work better is already a widely shared goal among policy makers in Africa. Strong financial systems have helped deliver rapid overall growth, as well as direct and indirect benefits, across the income distribution. Reflecting this understanding, policy reforms that have halted and reversed earlier deterioration have been adopted over the past decade. Governments have been building needed legal, information, and regulatory infrastructures. They have facilitated entry of—and competition among—solid financial intermediaries, national, regional, and international.

Important foundations have been laid, but it is clear that the performance of national financial sectors still falls short of its potential. Policy makers in many African countries are confronting similar issues and choices: how to get credit flowing more readily to where it can boost growth, how to get more finance for long-term and riskier projects, whether small national equity markets should collaborate across national borders, how best to design the regulation of banks and microfinance institutions in the African context, and where governments should concentrate their efforts.

The fact that such a wide range of fundamental questions is being asked in so many parts of Africa motivates the present regional study. Drawing on recent experience across the region and in international comparisons, *Making Finance Work for Africa* seeks to present a coherent and consistent policy approach that addresses African priorities and can work in African conditions.

This is a wide-ranging study that defies brief summary. But I am struck by three ideas, which recur in different forms throughout the book.

First, there is a clear institution-building agenda whose building blocks will yield clear benefits over time. At the same time, scope also exists for energy and imagination in adapting and applying universally sound principles to local conditions.

Second, despite the sometimes problematic political overtones, there is much to be said for being open to regional or international solutions. The reentry of foreign banks and the renewed interest in multicountry regulatory agencies show that this thought already has its adherents. International partnerships and outsourcing are also key to making the most of new technologies that are providing innovative solutions to the challenges of access to finance.

Third, countries have benefited from adopting an inclusive approach. By an inclusive approach I mean ensuring not only that reforms are targeted at embracing all income groups and sectors, but also that regulators facilitate the emergence and growth of a range of different types of intermediaries and ownership structures, and of different types of financial products.

The low level of private sector investment is both a cause of Africa's growth shortfall and a consequence of low confidence engendered by the repeated setbacks in most countries in the region. Escape from these conditions can hardly be imagined without a central role for finance. Policies that strengthen finance will also address these core development gaps. By providing an alternative to government patronage as the basis for entry into business activities, a strong, independent financial system can transform the business environment. Financial development can also generate a lock-in effect that raises the commitment of national elites to growth-oriented policies.

Making finance work for Africa is thus one of the most central and far-reaching of development goals for the continent.

Gobind T. Nankani
Regional Vice President for Africa
The World Bank

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Abbreviations

AERC	African Economic Research Consortium
AGO	Angola
AIDS	Acquired immunodeficiency syndrome
AIM	Alternative Investment Market
AML–CFT	Anti-money-laundering and combating the financing of terrorism
ASSOPIL	Association pour la Promotion des Initiatives Locales (Benin)
ATM	Automated teller machine
BAO	Banque de l’Afrique Occidentale
BCCI	Bank of Credit and Commerce International
BDI	Burundi
BEN	Benin
BFA	Burkina Faso
BIMAO	Banque des Institutions Mutualistes d’Afrique de l’Ouest
BNDA	Banque Nationale de Développement Agricole (Mali)
BOAD	Banque Ouest Africaine de Développement
BRVM	Bourse Régionale des Valeurs Mobilières
BWA	Botswana
CAF	Central African Republic
CAMCCUL	Cameroon Cooperative Credit Union League
CCP	Compte chèque postal

CECP	Caisse d'Épargne et des Chèques Postaux (Côte d'Ivoire)
CEMAC	Communauté Economique et Monétaire de l'Afrique Centrale
CERUDEB	Centenary Rural Development Bank (Uganda)
CFA	Communauté Financière d'Afrique (West Africa)
CFA	Coopération Financière en Afrique Centrale (Central Africa)
CGAP	Consultative Group to Assist the Poor
CIV	Côte d'Ivoire
CMA	Common Monetary Area
CMR	Cameroon
CNE	Caisse nationale d'épargne
COG	Republic of Congo
COM	Comoros
COMESA	Common Market for Eastern and Southern Africa
COWAN	Countrywomen's Association (Nigeria)
CPV	Cape Verde
DBSA	Development Bank of Southern Africa
DFI	Development finance institution
EAC	East African Community
EADB	East African Development Bank
ECOWAS	Economic Community of West African States
EMU	European Economic and Monetary Union
ERI	Eritrea
ESAAMLG	Eastern and Southern Africa Anti-Money Laundering Group
ETH	Ethiopia
EU	European Union
FADU	Farmers' Development Union (Nigeria)
FDI	Foreign direct investment
FECECAM	Fédération des Caisses d'Épargne et de Crédit Agricole Mutuel (Benin)
FENACOOPEC-CI	Fédération Nationale des Coopératives d'Épargne et de Crédit de Côte d'Ivoire
FGHM	Fonds de Garantie Hypothécaire du Mali
FSA	Financial Services Authority (United Kingdom)
FSAP	Financial Sector Assessment Program

FUCEC	Faïtière des Unités Coop
GAB	Gabon
GDP	Gross domestic product
GHA	Ghana
GHAMFIN	Ghana Microfinance Institutions Network
GIN	Guinea
GMB	Gambia
GNB	Guinea-Bissau
GNI	Gross national income
GNQ	Equatorial Guinea
HIV	Human immunodeficiency virus
ICA	Investment Climate Assessment
ICT	Information and communications technology
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPO	Initial public offering
KEN	Kenya
KenGen	Kenya Electricity Generating Company
KPOSB	Kenya Post Office Savings Bank
KUSCCO	Kenya Union of Savings & Credit Co-operatives
LBR	Liberia
LSO	Lesotho
MDG	Madagascar
MDV	Maldives
MFI	Microfinance institution
MGA	Mutual guarantee association
MLI	Mali
MOZ	Mozambique
MRFC	Malawi Rural Finance Corporation
MRT	Mauritania
MSME	Micro, small, and medium-scale enterprises
MTN	Mobile Telephone Networks (South Africa)
MTO	Money transfer operator
MUS	Mauritius
MWI	Malawi
NAM	Namibia
NASFAM	National Association of Small Farmers (Malawi)

NER	Niger
NGA	Nigeria
NGO	Nongovernmental organization
NMB	National Microfinance Bank (Tanzania)
OIBM	Opportunity International Bank of Malawi
PAMECAS	Projet d'Appui aux Mutuelles d'Épargne et de Crédit au Sénégal
PIN	Personal identification number
PoS	Point of sale
PPP	Public-private partnership
ROSCA	Rotating savings and credit association
RTS	Remote Transaction System
RWA	Rwanda
SACCO	Savings and credit cooperative
SADC	Southern African Development Community
SAFEX	South African Futures Exchange
SDN	Sudan
SEN	Senegal
SLE	Sierra Leone
SME	Small and medium-scale enterprise
SMS	Short message service
SOM	Somalia
Stanbic	Standard Bank of South Africa
STP	São Tomé and Príncipe
SWZ	Swaziland
SYC	Seychelles
TCD	Chad
TGO	Togo
TZA	Tanzania
UCB	Uganda Commercial Bank
UEMOA	Union Economique et Monétaire Ouest Africaine
UGA	Uganda
WAMZ	West African Monetary Zone
ZAF	South Africa
ZAR	Democratic Republic of Congo
ZMB	Zambia
ZNCB	Zambia National Commercial Bank
ZWE	Zimbabwe

Setting the Scene

Introduction: The Role of the Financial Sector

A decade of reforms—

There are stirrings of change in African finance, some of them vigorous. Strengthened by an extended wave of reforms over the past decade, financial systems in many African countries have begun to diversify their activities, deepen their lending, and increase their reach with new products and new technologies. Financial repression and the practice of directed credit are both much diminished, and there has been extensive privatization of state-owned banks—often to foreign-owned banks, the reentry of which represents only one aspect of a growing potential in internationalization and regionalization. A microfinance movement with deep roots on the continent has strengthened with organic growth and new entrants. Growing links between microfinance institutions (MFIs) and mainstream banks illustrate the adaptation of organizational structures to local conditions.

The persistent failure—until a decade ago—of formal and semiformal finance to advance, thereby leaving a fragmented and dualistic financial system stubbornly in place, thus seems to have been overcome. A new wave of intermediaries, many of them market based, has begun to adopt new approaches that promise to address the special challenges that confront financial development in the region. Cell-phone technology is being

used for retail payments and for price transparency. Modern technology also underlies the surge of retail lending in several African countries.

—But there is still much left to do

Of course, these countries still have a long way to go. The continued shallowness of finance and the limited access by small firms and households to any formal financial services, especially in rural areas, mean that this financial awakening is just a turning of the corner. The environment for financial firms remains difficult, and progress has not been as fast as had been hoped. The combination of improvements and unfulfilled potential warrants a new look at African finance.

To some extent, the condition of national financial systems reflects general economic conditions in each economy. But a two-way process is at work: a strong financial system is a powerful engine of growth—and equality.

Finance can expand opportunities and reduce risks—

The economies of East Asia have shown how putting national savings to work in productivity-increasing investment can sustain rapid growth over a generation. Microfinance innovations in Asia and Latin America have helped low-income households manage risks through savings. Such innovations have empowered energetic microentrepreneurs, giving them the first step up the ladder of prosperity and lifting living standards in the areas where they operate. Innovations in the technology for remittances and novel techniques in insurance have also played an important role in improving welfare.

By bridging the gap between savers and entrepreneurs, financial systems not only reduce the risks on both sides but also open up opportunities to both sides. They can reduce the barriers to entry for entrepreneurs, thereby allowing the economy at large to benefit in terms of increasing employment, improving the price and quality of services, and reducing the stifling influence of established monopolies. Given access to the necessary finance, farmers can move to a higher level of productivity and output. Savers, too, can share in the returns on an expanded flow of investment. Housing, insurance, and pension arrangements can be lifted onto a new plane.

—But governments must provide a supporting policy environment

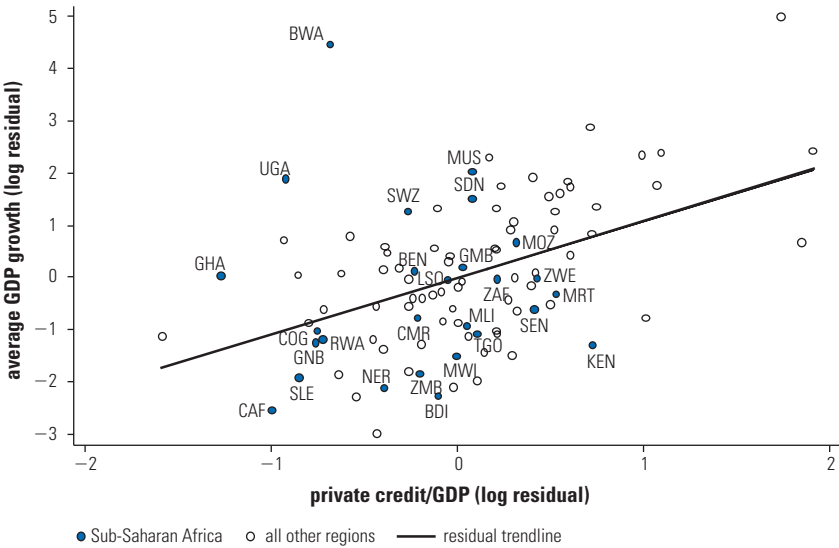
Increasingly, scholars acknowledge that supportive policy for financial sector development is a key component of national development policy.

Indeed, careful comparative analysis of the growth rates of different countries over a 30-year period has produced convincing evidence that having a deeper financial system contributes to growth—and is not merely a reflection of prosperity (figure 1.1).¹ Countries with deep financial systems also seem to have a lower incidence of poverty than others at the same level of national income. At the firm level, growth also responds to access to credit and to the conditions that favor such access.

Finance and social change

Strong financial systems are built on good governance, certainly both of the intermediaries and their regulators. In addition, because all sizable enterprises and all government agencies do business with the financial sector, improvements in this dimension of the financial sector have a pervasive leavening effect on the quality of governance in the business and government sectors as a whole.

FIGURE 1.1
Gross Domestic Product (GDP) Growth Rates and Financial Depth, 1980–2003



Source: Based on data in Beck 2006.

Note: Country abbreviations are included in the abbreviations list at the front of the book. This figure plots for 99 countries the relationship between private credit from the banking system, expressed as a percentage of GDP, and average annual growth in GDP per capita, controlling for the effect of initial (1980) GDP per capita, inflation, trade openness, government consumption, average years of schooling, and black-market premium.

Without a well-functioning financial sector to allocate and reallocate resources available for investment, African societies in which a closed group of incumbents (public or private) makes most of the investment and strategic decisions, because only they have the resources to implement large-scale plans, risk stagnating (see Eifert, Gelb, and Ramachandran 2006; Rajan and Zingales 2003). By allocating and reallocating resources on a more objective basis of creditworthiness and prospective returns, a finance-rich economy is more conducive to a wider distribution of economic power and influence, which in turn should feed back into improved national economic performance on many dimensions.

Financial development can help broaden the elite class because wealthy and middle-class people can acquire a share in the success of local economic ventures and begin to define their own prosperity in terms of national prosperity without reference to ethnic or local advantage. One concrete example is the way in which national elites have become interested in the fortunes of recently privatized firms, which though often majority owned by foreigners have a fraction of their ownership listed on local exchanges. If elites are invested in national economic prosperity (rather than defensively attempting to secure—for a time—their share of a static or declining pie that may at any time be swept away by social or economic crisis), they may work harder to introduce policies that underpin economic growth.²

Key Policy Issues

What policy responses are now needed to foster the new energy; to help ensure that modern technology, organizational innovation, and internationalization are exploited to the maximum; and to help ensure that investable funds are well allocated to underpin growth and to protect against any future risks?

The agenda for financial sector policy reform and strengthening is a long one. A practical strategy needs to take into account implementation constraints. Furthermore, some reforms require preconditions in the wider economic and political environment, without which they will be ineffective or even counterproductive.

What should guide African decision makers in prioritizing policies to strengthening financial sectors? This report suggests a two-pronged approach:

- Economic growth is the surest way to a substantial and sustained reduction in poverty in Africa; policy for long-term growth requires focusing on the larger and more formal parts of the financial system.
- But even while growth-enhancing policies are beginning to have their effect, improving the access of low-income households and microentrepreneurs to financial services should become an additional central focus of financial sector policy.

Thus, consistent with the two policy prongs of growth and access, the most pressing needs in African finance are (a) to increase the availability and lower the cost of credit to productive enterprises and (b) to extend the reach of basic savings, payments, credit, and insurance services for low-income people and for the smallholder farms and microenterprises that provide their livelihood. Africa also needs a wider range of longer-term facilities (including mortgage finance); greater possibilities for risk management and diversification, including more transparent price discovery; and improved marketability of tradable securities, such as debt and corporate equity. Each of these areas makes demands on scarce technical and managerial skills, including prudent management, regulation, and supervision.

The two prongs will have overlaps; indeed, in time these overlaps will tend to grow as the larger intermediaries find ways of applying technology to reach a wider clientele. The challenges of agricultural finance will remain central for both prongs. Scaling up high-productivity agriculture and agribusiness will remain an important part of the growth process in most African countries; large-scale agricultural enterprises will remain important customers of the main banks. For most farmers and rural workers, their main point of contact with the financial sector will be at the micro level.

For the most part, the growth and access prongs do not interfere: conflicts or tradeoffs between the two goals are encountered only rarely. It is possible to move forward on both fronts.

African financial systems are not all the same;³ they are spread across a spectrum of financial sector performance. Nevertheless, sufficient similarities exist between the underlying economic conditions that face financial firms in most of the countries to allow several generalizations. In addition to low savings rates, finance in most African countries works within an environment that is extreme in four key dimensions: scale, informality,

governance, and shocks. Although similar difficulties are found elsewhere, the frequency with which this quartet of environmental obstacles meets up together in Africa means that policy analysis in the region has a distinctive flavor.

- *Scale* refers to the small size of the economies and even more of the national financial systems and firms and their customers. Sparse population, resulting in isolation and great distances (at least in terms of travel time) to points of services, is another aspect of what is included under the heading of scale. Because most financial services involve fixed costs and increasing returns of scale (at least up to a certain point), the problem of scale translates into a problem of high unit costs and even unaffordability of certain services. Possible solutions include rigorous attention to cost control, reliance on internationalization to benefit from a sharing of some of the fixed costs, and reliance on information and communications technology that can result in lower unit costs.
- *Informality* refers to the status not just of client enterprises of financial intermediaries but also of the markets within which they work; informality reduces the degree to which reliance can be placed on systematic documentation, adherence to a predictable schedule, or even a fixed place of business.
- *Governance* problems arise at the level of private and public institutions but are probably relatively more severe in the public sector. This problem reduces the credibility and stability of government policy and increases the danger that policy goals will be subverted in implementation.
- Not all types of *shocks* are more severe or more frequent in Africa than elsewhere, but the continent's history over the past half-century has been marked by a high incidence of occasional economic or political meltdowns (associated with conflict, famine, and politico-societal collapse as well as with external factors) at a frequency of up to one per decade per country (Arnold 2005; Meredith 2005). At the micro or "idiosyncratic" level, risk is also very high for individual households near or below the poverty line and for small farms and firms.

So that financial services can be delivered safely and at reasonable cost despite these difficult conditions, stakeholders need to find solutions draw-

ing on innovations in financial, information, and communications technology; internationalization; and well-adapted organizational structures.

Bearing in mind this quartet of environmental challenges, we now turn to the two major approaches that are conventionally adopted to pursue financial sector reform in Africa.

Modernism and Activism: Two Perspectives for Reform

Building and preserving an enabling environment for domestic finance to flourish is a goal on which all will agree. African policy reforms to date have gone some distance toward stabilizing the macroeconomy and removing incoherent administrative controls on wholesale interest rates. Regulatory authorities have rightly intervened in insolvent banks; many of them have been recapitalized and placed under better management and ownership. Among many other reforms, a lot has been done to improve the regulatory framework for banking (Aryeetey and Senbet 2004).

Clearly more is needed, but what? There can be no dispute about the importance of macroeconomic stability, contractual certainty, and policy and commercial transparency as the foundations of an effective financial system (see box 1.1). That is not to say that these foundations are securely in place throughout the continent—far from it. Macroeconomic instability, though much less evident than a decade ago, is still a threat in certain parts; crowding out by government borrowing has been evident in several countries; and the risk of major policy reversals is routinely factored into investor decisions. Reforming the legal and judicial system and improving financial information and transparency are tasks that are far from complete.

Certain building blocks, including rationalization and clarification of laws, streamlining of court procedures, establishment of credit registries, and training of financial professionals, are well accepted as key components in moving toward more effective financial systems. This book does not dwell on these widely agreed goals and building blocks—which are not Africa-specific.⁴ Instead, the focus is on matters that are not so clear but speak more specifically to Africa's distinctive needs.

Two distinct but complementary perspectives to the strengthening of African financial systems prevail in current policy discussion. They can be summarized as the modernist and the activist perspectives. Both accept the

BOX 1.1

Stability, Certainty, and Transparency: Foundations of Financial Sector Efficiency

Three of the most important background aspects of the economic and institutional environment contributing to efficient financial sector functioning are macroeconomic stability, certainty of contract enforcement, and availability of information.

Macroeconomic stability is particularly helpful for encouraging banking development. Low and stable inflation encourages monetary savings by making the real value of savings more predictable. Fiscal discipline allows mobilized savings to be channeled to the private sector and prevents the crowding out of private investment by government borrowing demands.

Lenders and investors are more willing to enter into financial contracts where more certainty exists about the relative legal rights of borrowers, creditors, and outside (minority) investors and if fair, speedy, and impartial enforcement can be confidently expected. Legal systems giving greater relative weight to the rights of creditors compared with borrowers and to the rights of minority shareholders compared with majority shareholders and management, for example, promote deeper debt and equity markets, respectively. Ideally, creditors should have effective ways of enforcing contracts outside bankruptcy as well as maintaining creditor rights within the

importance of the overall enabling environment but seek to look beyond those basics. Both perspectives have validity and an appropriate range of application. Misunderstandings and policy debates can often be interpreted in terms of a clash over which perspective is more relevant and more likely to be effective in meeting different dimensions of African needs.

Putting in place the infrastructures necessary for effective functioning of the financial sector will require a protracted period of modernization. There is no doubt that modernization represents the bedrock of any credible vision for national financial sectors, whether in Africa or elsewhere.

The modernist perspective sees finance as an anonymous, atomistic, market-oriented mechanism that disregards the pedigree or power of its users except to the extent that such power influences the remuneration of

bankruptcy procedure. Effective functioning of property registries and courts is critical to the creation, perfection, and enforcement of security interests. Shareholders need not only sufficient information but also the possibility to influence company decisions directly through votes on critical corporate decisions and indirectly by their voice in the selection of directors. More important than the laws on the books, however, is the actual enforcement in practice. In this context, fighting corruption and fortifying corporate governance are both key.

Finally, effective financial intermediation depends on tools to reduce the information asymmetries between provider and borrower that can restrict intermediation because of the associated adverse selection and moral hazard. Transparent financial statements are crucial for reducing screening and monitoring costs for lenders and thereby increasing the efficiency of resource allocation. Credit registries that give easy and reliable access to clients' credit history and both negative and positive information make borrower quality much more transparent, making it safe for lenders to lend to a wider range of customers with a satisfactory credit history (see Beck 2006).

At the same time, it is worth remembering that the link between risks and the importance of the financial sector is a two-way one. When risks are high, financial contracts can help market participants hedge or pool these risks. In this way, the financial system can be a valuable buffer for the rest of the economy, though in practice it is more effective in insulating short-term risks than long-term risks.

each financial contract. This perspective casts a suspicious eye on the integration of industrial and financial power, because the emergence of concentrated industrial-financial groups can have the effect of blocking entrepreneurship by those outside the main power groups. Integration of finance and government is also questioned for similar reasons (hence the low standing, from the modernist perspective, of state-owned banks).

The modernist perspective concerns itself mainly with large-scale finance—deepening the resource mobilization of the banking system, ensuring that banks want to and can safely lend on these resources, and enabling productive formal sector firms to find the mix of equity and debt finance they need to grow, as well as sophisticated tools for risk management.

Governments have a central role here, not least in creating the enabling environment. The policy agenda associated with the modernist perspective focuses on the macroeconomic, contractual, and information frameworks, with the objective of reducing information asymmetries, improving legal certainty, and lengthening investors' planning horizon. This agenda includes updating laws governing financial contracts and ensuring their proper and reliable enforcement through judicial reforms to make certain that property rights are clearly defined and enforceable, both in general terms and as they apply to specific modern financial instruments. It also focuses on defining and updating accounting rules and procedures to ensure that enterprise accounts are a reliable basis for investment and other financial relationships, as well as on improving systems of credit information sharing to allow borrowers to use their reputation as collateral. Increasing the predictability and stability of government policies as they affect the overall macroeconomic environment is also an important desideratum for the modernist, as systemic risk impedes the functioning of finance—even if integration with global finance can mitigate this problem.

The touchstone for the modernist is “best practice” of the advanced market economies. Transplanting best practice is acknowledged as likely to take time, but the modernist is inclined to see any move in that direction as progress. As we will argue, this view is where the modernist may overreach in Africa. Modernists sometimes neglect real-world constraints. Disappointing results can be expected from a mindless transplantation of overambitious structures from the advanced economies. Indeed, although modernization may seem low risk, it can cause problems if introduced in an unfavorable environment. For example, the design of African stock markets—influenced by what was seen as best practice in advanced economies—may (as discussed in chapter 3), through costs and prerequisites, have created barriers to listed equity finance for many African firms that could have obtained it if a more context-sensitive regulatory design had been chosen.

Applied with a realistic attention to national context, however, the modernist agenda does help to build the foundations of an effective financial system for the long run. As implied by the term we have used for it, what the modernist perspective offers directly is modernization more than economic growth, but growth comes with and as a result of successful modernization. And although modernization is maturing, policy makers

need to be actively engaged in encouraging the numerous initiatives that financial market participants are already taking to reach a wider market.

The *activist* perspective to finance is concerned with achieving results in areas where the anonymous private financial sector is not conspicuously successful: finance for agriculture and the rural economy, for micro- and small enterprises, and for low-income households, as well as long-term finance in general. Inherent difficulties, risks, and costs impede the effectiveness of finance in each of these areas. The occasional collapse of financial intermediaries and the economic dislocation that often accompanies such crises are also the target of the activist perspective.

The activist sees the need for special interventions to help correct the market failures here. These interventions include enacting restrictive legislation and establishing competent and politically independent prudential regulators to guard against weak, reckless, or corrupt management of financial intermediaries that could cause their collapse. Protecting the consumer from predatory practices is also high on the activist agenda.

The activist sometimes advocates a variety of special public, charitable, or otherwise privileged intermediaries. Because of the disappointing performance of many publicly owned financial firms (all too often subverted through a politicized management or through corruption), the risk of overreaching in this regard is well known. Even though the deficiencies that gave rise to state ownership persist today, few close observers of financial systems around the world now recommend the establishment of government-owned development banks in African countries. Effective governments will have learned the lessons of the past and, to avoid counterproductive interventions resulting from weak governance, will support—but will not themselves take the lead in—implementing the activist agenda by increasing their direct engagement in providing financial services. The potential for regional entities and for partnerships with local and international nongovernmental organizations (NGOs) and with the private sector to fill this gap needs to be explored; donors, too, can have a potentially valuable role as disinterested activists in bolstering specific initiatives.

Imposing impracticably low interest rate ceilings in a misconceived attempt to protect borrowers is another familiar activist error, which chiefly results in reduced flow of formal sector credit to those who could most benefit from it.

But it would be a major mistake to think that these instances can be extrapolated to discredit the activist perspective on a broad front. In partic-

ular, the rapid growth and many success stories have encouraged individual social entrepreneurs as well as international donors and others to promote the creation and expansion of microfinance firms in Africa as in other developing countries. This result can be seen as consistent with the activist perspective.

Activism is most effective when it achieves its effects by realigning the incentives of the relevant market participants. It should be attempted only by entities that have adequate governance. This requirement poses a problem for many governments in Africa, as cross-country surveys confirm.

Sometimes it is not immediately clear whether certain policies should best be considered modernist or activist. The widespread, but relatively recent, adoption in almost all countries of a greatly intensified regime of bank regulation is sometimes presented as a modernist agenda, even though it responds to a series of market failure events. Restrictive legislation on bank behavior and the establishment of competent and politically independent prudential regulators to guard against weak, reckless, or corrupt management of financial intermediaries that could cause their collapse is part of the standard policy package in both advanced and developing economies these days, but it can easily be seen as part of the activist agenda. Indeed, as markets become more integrated and sophisticated, the modernist view among scholars has begun to emphasize market discipline in preference to regulatory discretion in bank regulation.

The conclusion of the present study is that only through a pragmatic and context-sensitive combination of *both* modernism and activism can good results be expected. Pursuing only one or the other would leave Africa without many of the financial services it so badly needs. The relevant aspects of the context that need to be taken into account in African countries include the cost and complexity of each type of intervention, the ease with which abuses and subversion of the policies can be limited (especially in the context of weak governance), and enforcement capacity.

Ultimate Goals: Financial Sector Development for Growth and Poverty Reduction

As Sachs (2005) has pointed out, well-targeted direct assistance to improve the productivity of subsistence farming productivity and to reduce disease can have a sizable effect on extreme poverty. This assistance, however, just

gets the poor to the bottom rung of the ladder. Helping them to the next rungs is the task of microfinance; building the ladder requires mainstream finance.

Reducing absolute poverty in conditions of anemic growth is all but impossible for a market economy.⁵ From a long-term growth perspective, the major channel for a sustained reduction in African poverty is a transformational increase in the share of the population that is working in the modern sector and with advanced economy productive techniques.

A more effective formal financial system would not only intermediate on a much larger scale, but in doing so it would help improve enterprise productivity and growth, not least in sectors that have the potential to contribute directly or indirectly to exports, especially exports of nontraditional goods and services. Faster national economic growth is the only sure way to a sizable and sustained reduction and eventual elimination of absolute poverty (as we know it today). In addition, improved access to financial services for poor people and people in rural areas would directly help improve their circumstances and help reverse what has, at least until recently, been a trend in the continent toward widening inequality and increasing poverty rates.

In terms of agriculture—which accounts for such a high proportion of output and especially of employment at present and will continue to form the backbone of the African economy for the foreseeable future—the required transition will be toward a situation in which, although farms may be largely family controlled, they will be less labor intensive and on a much larger scale than at present.

It follows that accomplishing this long-term growth agenda needs the machinery of efficient mainstream finance. Only in this way will there be a ladder for the poor to climb. Of course, in addition to having access to effective financial services, the international and domestic private sector will be able and prepared to invest in modern productive structures only to the extent that complementary factors, including human capital and physical infrastructure, as well as other necessary conditions of the business environment, are present.

Effective finance has a role to play in contributing to these complementary factors also. The right financial arrangements can speed and improve the provision of physical infrastructure. And the legal and information infrastructures needed for effective finance also help improve the overall governance and business environment.

At the small scale, finance is relevant to helping ensure that human capital gets created. Investment by households and individuals in health and education requires insurance, savings, and sometimes borrowing services, without which families are often unable to acquire the needed skills. So finance at the small scale helps support the creation of the skilled and healthy labor force, which is among the most important prerequisites for the willingness of entrepreneurs to embark on the needed investments. Returning to the analogy of climbing a ladder, these are the second and third rungs up the ladder—the part of the climb that small-scale finance can help, once the bottom rung has been reached.

Although this vision provides the long-run goal toward which policy should be aimed, much of Africa will not have completed this transition for many years to come. The bulk of the population will still depend on a more unstructured and unsystematic, low-productivity economic structure. Even if amelioration of their condition in such structures is not directly conducive to achieving the growth-delivering economic transformation spoken of above, it should not be neglected. Financial services for microenterprises, even of low productivity, and for low-income households directly speak to a reduction of poverty.

Policy Perspectives for the Major Elements of the Formal Financial Sector

Finance at the large scale is provided in general by large and influential financial firms—banks, insurance companies, pension funds, securities market specialists, and so forth. As a general observation, if the provision of mainstream financial services in African countries is to improve as to quantity and quality, more competition and a greater presence of strong, profitable financial firms are needed. That requirement certainly means policy should create a favorable environment for doing financial business, but it does not mean that what is good for existing financial firms is necessarily good for the economy as a whole.

Clearly, the managers and owners of these firms are experts, and their opinions must be taken seriously in policy design. Their recommendations often seem to represent the modern solution. But this is not necessarily always the case. After all, in a typical well-balanced economy, the financial sector serves the rest of the economy and not the other way around. This

observation is crucial for policy design, because the political and economic power of major financial sector players may tend to tip the balance into policies that make financiers wealthy (regardless of their effectiveness) as distinct from policies that favor financial sector efficiency. A vivid recent example of a major policy initiative designed to improve sector performance—rather than please incumbent suppliers—is the consolidation of the Nigerian banking system resulting from the increase in minimum capital. This ownership shake-up may not have been welcomed by many incumbents, and there is the risk that the high entry barrier represented by the new minimum capital could reduce competition. It is too early to pass judgment, but if the end result is reduced rent seeking and greater professionalism by the elimination of numerous small banks, it will have been a good idea.

Banks are and will remain at the heart of African financial systems. Their effectiveness could be greatly improved if stronger underlying infrastructures existed, including in the information and, especially, legal dimensions. Banks can function without, for example, a robust regime of land-ownership rights⁶ and without a predictable judiciary, but they do so in a manner that is greatly constrained. Absence of these infrastructures reduces bank lending (as is reflected in the high liquidity prevailing in many African banking systems) and increases the necessary spread for those who do get to borrow (both for covering administrative costs—because neither large depositors nor liquid asset markets will cover those—and because of heightened loan loss risks). A full resolution of these legal issues is not something for which a quick technical fix is readily available—although some easy steps can help. The long-term solutions may be country specific and will certainly require political follow-through.

Extensive ownership changes have occurred in African banking following the bankruptcy of many banks, including state-owned banks. International banks have returned in force: new entrants from South Africa, returning ex-colonial banks from Britain and France, as well as a handful of intercontinental South-South links, especially from the Gulf and South Asia. A new wave of regional banks within Africa is also flourishing. Yet state presence lingers more than is immediately evident. For one thing, numerous state-owned near-banks still exist, including development finance institutions. Furthermore, several large, formerly state-owned commercial banks remain state controlled, with direct government ownership being supplemented by parastatal shareholdings. Lip service to the

concept of privatization can leave a bank even more vulnerable to the weaknesses that are often associated with state ownership. And political pressures on lending decisions of banks—both state owned and private—continue to be a problem in some countries.

The lack of long-term finance is partly a reflection of the long-term risks already mentioned and partly an endogenous response to the need for monitoring and recontracting. In some countries, it is caused by a regulatory-induced bias restricting maturity transformation. Finally, across Africa, there is a paucity of long-term resources available for investment. Although pension funds, social security, and life insurance are natural providers of such funds, more could be done to encourage those entities to actively seek out long-term uses for their funds. However, good governance of these funds needs to be ensured, and that will be facilitated if active securities exchanges exist on which their investments can be priced.⁷

For the present, most organized African securities markets are largely primary markets with relatively little secondary activity. Perhaps an over-elaborate model of regulation has been adopted for these markets (the modernist model overreaching itself), effectively precluding small issuers, yet failing to achieve substantial liquidity for larger issuers.

With the failure of several state-owned insurance companies and the entry of regional or international firms to provide the basic insurance products, general insurance is gradually making a comeback in Africa. But the potential complexity of insurance business makes it essentially a business in which the buyer must beware. Most national regulators are ill equipped to assess and discipline fraudulent or reckless insurers. Insurance is a good candidate for regional cooperation in supervision—potentially as an annex to banking supervision.

Regional cooperation and integration have long seemed to offer possible solutions to problems of small scale. Regional integration could be further pursued in numerous dimensions. Currency unions are firmly on the political agenda. At present, just three working examples survive of a more numerous set of colonial relationships. Despite political commitment to single-currency programs (undoubtedly inspired by the European Economic and Monetary Union, or EMU, project), most practitioners do not expect further single currencies to become a reality in any short time-scale, especially given the diversity of national macroeconomic policy conditions and the inability of most African governments to provide a fully credible commitment to a single currency. A more plausible candidate area for fur-

ther integration is supervision of banks and other intermediaries (with the two international agencies of the CFA zones now well established and offering one potential model) and securities markets (one already, others in the planning or development stage). It might be more fruitful to redirect political will in the short run to cooperation on bank and other intermediary supervision and to exploitation of regional gains from stock market integration.

Aggregate national resource mobilization is primarily a matter of convincing the wealthy that they can safely leave their deposits in the local banks. That means macroeconomic and political stability, sound banks, adequate competition, and a quasi-tax regime that allows reasonable rates of interest to be paid. Absence of these conditions helps explain why African savings rates have been low. A new technical challenge to achieving sustained macro balance without choking off growth is emerging from increasing aid flows (as well as from the effects of the oil price boom in oil-producing countries). The willingness of the private sector to hold money onshore is likely to grow in line with the improved prospects created by these inflows, thereby allowing greater financial deepening without triggering unduly restrictive credit policies.

Helping more people to access deposit services is also important and commercially possible, but its social value lies in a different dimension entirely from that of aggregate resource mobilization—namely from affording the depositors an important liquidity, precautionary saving, and accumulation function. Offering deposit services can also be a key to the healthy growth of the MFIs that serve low-income clients.

Reaching Difficult Markets

At most, 20 percent of African households have any access to formal finance.⁸ Even medium-scale enterprises have difficulty accessing credit and the other financial services they need to grow.

The major problems are twofold. First, intermediaries have difficulty delivering their products to poor or remote customers—let alone adapting product design to these customers' needs—at an affordable cost. Cost penalties particularly relevant in Africa (though also observed in other parts of the world) include the small size of the market at both national and local levels, which is partly attributable to low geographic density of

population and pronounced economic isolation (especially in rural areas). This factor is compounded by the deficiencies of transport and communications, as well as extremely low transaction sizes and the inappropriateness of some standard products to the needs of small clients. Lack of competition adds to the cost penalties experienced by clients.

Second is the difficulty of assessing creditworthiness and enforcing contracts. Low levels of perceived creditworthiness in Africa relate to the poor quality and scarcity of information about individual risks as well as to high incidence of shocks (weather, health, social disruption) exogenous to the agents and often systemic or at least covariant. Weak legal and judicial and other information and contract enforcement infrastructures are also a pervasive underlying factor here.

Despite a newfound interest on the part of some of the big banks in reaching parts of the market in which they have not been active before—the small farmer, the rural or urban poor, the middle-class would-be homeowner—it would be unwise to assume that their unaided efforts are guaranteed to overcome the formidable challenges that face such an effort. Although the banks may have the resources to meet the overhead costs of setting up new systems that can help reach rural households and meet the financial service needs of small farmers, they will have to work hard to make sure that the unit costs of operating these systems are sufficiently low.

Governments can assist banks and other private financial intermediaries in this regard through efforts to build and repair various hard and soft infrastructures that are essential ingredients in rolling out financial services widely. Improving the functioning of courts as enforcers of contracts and property rights—whether through legislative changes to reduce the complexity and cost of unnecessary court procedures, through training and selection of judges and an effective system of sanctions for judicial corruption, or through efficient mechanisms for enforcing judgments—is one area in which the need for reforms is clear and on which some of the initial steps in that direction can be taken without too much difficulty, technical or political. Likewise, it is not too difficult to clarify laws and tax rules in order to smooth the way to a wider use of leasing and factoring—credit techniques that have long proved effective in reaching borrowers with limited scale and weaker creditworthiness. Building the credit information infrastructure—from registries of secured claims and credit bureaus to accounting rules and the performance of the audit profession—is a longer process but also eminently feasible. Recasting land-ownership claims in such a way as to make land

usable as collateral may be a tougher challenge. It may require a political campaign to refocus public awareness of the relative benefits of modern market-based land-ownership structures in comparison with tribal or other conventional land-tenure systems or with socialism; even more important, the opposition of those who have a vested interest in the current arrangements for the control of land will need to be overcome.

Even if these modernist “meso-level” initiatives are accomplished, lending—and borrowing—in Africa will remain a challenge. The necessarily unsystematic and unstructured nature of African business transactions, especially in the informal sector, is one major reason simple solutions are not available. In these conditions, lenders must reach deeper into classic loan appraisal techniques. Micro-, small-, and medium-scale enterprises’ access to credit from the formal financial sector will depend in large part on the degree to which banks and other formal intermediaries are motivated by profit or social concern to make this more elaborate and necessarily more costly effort. If the effort is to be worth making, it is crucial that neither governments nor donors spoil the market (as they have in the past) with simplistic and heavily subsidized credit interventions that will be captured by those who would have received credit anyway, do not need the subsidy, and could have provided profitable business to share the costs of market-dependent intermediaries.

Experience shows that successful lenders in Africa go beyond the mechanical rules and procedures that work well in more settled environments. *Relationship lending* is probably the best umbrella term⁹ to describe the tailored investment in credit appraisal, the flexibility of response to excusable delinquency, and the imaginative approaches to renegotiation and recovery that are needed to be a successful lender to the middle market in Africa. This strategy requires experience and skills and may at first not always yield financial rewards commensurate with the skills employed. That is why charitable NGOs and donor agencies are active in these areas. Commercial concerns are also engaged, and provided that they have a long time horizon and deep pockets, they should also be able to make a success of this method if they are not undercut by subsidy or blocked by overelaborate or poorly designed prudential regulations. Facilitating their activities and helping them reach scale while controlling costs must be a top priority of financial policy authorities in African countries.

Credit and noncredit financial services—such as deposits, payments (including domestic and international remittances), and insurance—have

a tough time reaching rural areas, farmers, and low-income households. Different main sources of difficulty can easily be seen for each of these three categories. Rural areas are by definition more remote than urban areas, and in most African countries the population is very dispersed indeed. Farm enterprises are rarely able to benefit as immediately and deeply from the most common techniques of sustainable microfinance as are small urban traders. This difficulty arises not only because of the short-term and progressive nature of the lending relationship but also because the relatively high break-even interest rates (see box 1.2) that have to be charged for sustainable microfinance are often out of line with the rates of return that can be achieved in most of African farming today—even if such returns are reliably in double digits. Finally, low-income households are hard to reach because they can rarely afford to pay the unavoidable fixed costs involved in any banking-type relationship, but it is not impossible.

It seems natural to look to financial engineering and technological advance to help overcome these difficulties. Already, innovators throughout Africa have been piloting a range of initiatives that can help. Several of these are described in chapter 4. Even if some have not yet reached commercial scale, they all show the general outlines of the way forward. Extending these experiments and conducting others is something in which all concerned—specialized MFIs, whether or not cooperative in structure; mainstream banks; governments; and donors—have their part to play.

Organization of the Report

Chapter 2 provides a quantitative stock-taking of Africa's financial systems. Financial depth is found to be somewhat lower than the worldwide average even after taking account of inflation and mean per capita income, especially for credit. Africans also have disproportionately high offshore deposits. Interest margins are high; international comparison pinpoints small scale, property rights institutions, and lack of competition as among the important causal factors. Apart from a few of the longest established, organized securities markets are small and inactive; institutional investors often concentrate on bank deposits and real estate instead. Microfinance has improved its outreach, though access rates in African countries remain behind those in other regions.

BOX 1.2

Microfinance: Sustainability and Outreach

The goal of achieving a large outreach and sustainability drives certain microfinance principles that also mesh well with the modernist perspective to mainstream finance. The *financial systems approach* to microfinance envisages microfinance institutions converging to financial self-sustainability. According to this approach, subsidies that are provided focus on setup and head-office issues, including product development, and are not directly used to subsidize lending interest rates at the margin (even when the subsidy is received in the form of a low-interest long-term loan that the MFI invests in treasury bills, using the net revenue to cover operating costs). As scale is achieved, such subsidies will tend to assume a relatively smaller part of the microfinance business (in a way that, for example, systematically distorting marginal pricing of interest rates would not). Even though the intention is usually to eliminate them, such foundation subsidies do tend to persist for a very long time.

The high interest rates (spread over wholesale rates) seen in unsubsidized microcredit—although much lower than those typically charged by moneylenders—result from the costs associated with intermediation of this sort and, in particular, costs that result from small scale. Microfinance can be successful in rural areas but is more widespread in urban and peri-urban settings, which points to the costs associated with remoteness and low density. By the same token, such high interest rates (and a fortiori such absences) mean that much potentially socially beneficial microlending simply does not take place. The same applies *mutatis mutandis* with respect to the pricing of deposits and insurance type products (see Helms and Reille 2004; Porteous 2006a).

Chapter 3 examines finance at the large scale and its contribution to national economic growth. The chapter considers the measures needed to boost financial depth and, in particular, to encourage banks to lend a higher fraction of the resources they mobilize. The role of different ownership structures in African banking—in particular the return of the foreign banks and the decline of development banking—is documented and interpreted. The best solution to long-term finance is not development bank-

ing. Instead, the long-term resources of pension funds and other institutional investors offer a more promising alternative source of term finance, though governance improvements are needed to underpin this source. The pricing transparency offered by active organized securities markets could help. The lack of volume and activity on existing exchanges is seen as partly attributable to an overambitious model of securities regulation: less onerous requirements could increase the scale and activity of the exchanges and their usefulness to smaller firms, without undue loss of investor protection.

Regional cooperation can help improve policy solutions in the areas considered in chapter 3, but there is a need to select the most promising among the numerous extant projects here, with intermediary supervision more immediately promising than currency union. If the external environment improves, careful policy design in other macro areas will be needed to ensure that resource mobilization increases in response and to guard against the danger that the growth dividend from incipient financial deepening is not choked off by unduly restrictive measures.

Chapter 4 turns to finance at the bottom of the pyramid, considering in turn the challenges faced in reaching a wider market for credit, insurance, deposits, and payments. Evidence and practical experience about what can work in an African environment are reviewed under each heading, with an emphasis on financial engineering and technology as key elements of the solution. Although activism is clearly needed here, different types of agents have different roles to play. The direct provision of financial services will remain largely in the hands of private financiers, albeit including cooperatives and donor-aided NGOs. Government needs to attach priority to creating policy structures that actively help these intermediaries reach cost-effective scale and that are not blocked by dysfunctional or excessive regulation. Donors can help fill gaps by acting as independent “agents of restraint” to prevent abuse where national governments so far lack the market credibility or governance institutions to intervene effectively.

Financial sector reform is a long haul, but in tackling it policy makers should be on the lookout for available shortcuts that can help without compromising stability and efficiency: they should be especially open to leveraging on what external agents can offer, and they need to ensure that policy is geared toward inclusiveness. The report ends (chapter 5) by addressing these issues of policy prioritization. It suggests two particular practical areas that may offer a high payback in most African countries

today—namely (a) boosting credit flows by strengthening registries and streamlining court procedures and (b) working on enhancing the independence of regulatory authorities. More generally, priorities will vary depending on the contrasting conditions that face African countries, and this point is illustrated for some specific extreme cases—postconflict countries, oil-rich countries, small countries, sparsely populated countries, and finally the few large countries able to avail themselves of critical mass.

Notes

1. The evidence pointing to a positive causal association between better-developed financial systems and faster economic development is based on analysis of a wide range of country-level, industry-level, firm-level, and internal country data. If we consider worldwide experience as a whole, financial development's positive effect on gross domestic product per capita growth comes through improving the efficiency of resource allocation and thereby productivity, rather than through financial development's effect on investment volumes (Levine 2005). The evidence for subgroups of countries is harder to interpret. Thus, the investment-volume channel may be relatively stronger in low-income countries, for which indeed the evidence for a causal effect of finance on long-term growth is less clear (Rioja and Valev 2004a, 2004b). However, Aghion, Howitt, and Mayer-Foulkes (2005) provide evidence suggesting a complex causal pattern for variations in the effect of finance at different levels of development. They find that once a country has achieved a certain level of financial development, more finance does not contribute further to growth, but growth in countries with low financial development does benefit from further financial deepening. Studies confined to African data also find a causal link between finance and growth (see Ghirmay 2004), but some suggest that the effectiveness of finance might be lower in Africa (Kpodar 2005).
2. A major Harvard-Oxford-African Economic Research Consortium (AERC) project, building on earlier work that was surveyed in Collier and Gunning (1999a, 1999b), has combined historical case studies and cross-country econometrics to try to understand the causes of Africa's low growth performance. While noting the role of exogenous factors ("opportunities") in holding back many African countries, the study points to a set of antigrowth policy ("choice") syndromes—control regimes, adverse redistribution, unsustainable spending booms, and state failure—that have accounted for the loss of between 1 and 2.5 percent per annum in median growth rates. According to the project's conclusions, avoiding these syndromes was virtually a necessary condition for rapid growth and virtually sufficient for avoiding the growth collapses that so often undermined sustained progress in Africa (Fosu and O'Connell 2006; see also Azam, Bates, and Biais 2005; Azam, Fosu, and Ndung'u 2002).

3. For example, the AERC-Harvard-Oxford Africa growth project emphasizes contrasting physical and political geographic preconditions for growth between African countries (see Fosu and O'Connell 2006); contrasting monetary regimes in Africa are highlighted by Honohan and O'Connell (1997).
4. A useful background resource for anyone wishing to assess the quality of a country's financial sector in terms of these standard building blocks is International Monetary Fund (IMF) and World Bank (2005).
5. But note also that, up until recently, in contrast to most other developing countries where both the numbers and percentage share of the population in absolute poverty have been falling, African countries have been characterized by a widening inequality gap, with more absolutely poor people alongside a middle class whose prosperity is—on average—gradually increasing (see Artadi and Sala-i-Martin 2003; Sala-i-Martin 2006). At the same time, however, certain nonincome social indicators have improved (Silva Lopes 2005).
6. Insecurity of individual land tenure in Africa has had implications well beyond those for access to credit, notably in its chilling effect on rural investment, as documented in microstudies such as Dercon, Ayalew, and Gautam (2005).
7. Another important and underrated benefit of equity markets is the way in which they can help to give elite groups and the upper-middle class a stake in economic systemic stability and growth through diversified and interlinked claims on the system achieved by portfolio (arm's-length) equity claims on firms operating in and reliant on the local economy (including banks).
8. To be sure, many more have recourse to informal finance for both household and enterprise needs. Indeed, the richness and persistent centrality of African informal financial networks for most Africans is a phenomenon that has fascinated observers. It is not to diminish the current importance of these networks to confine the present discussion to the formal financial sector. The formal sector is the main target of policy, and it will undoubtedly become increasingly important in serving the majority of African households and firms.
9. Relationship lending is to be distinguished from related party lending, where the lender has family, social, or nonlending business relationships with the borrower.

African Financial Systems: Depth, Breadth, and Efficiency

Introduction: International Comparisons

An underdeveloped financial system—

Given the proposition underlying the discussion of the previous chapter—namely that financial development is important for economic development and poverty alleviation—how do Africa’s¹ financial systems stand in international comparison? Is a low degree of financial depth, efficiency, and access simply a question of economic development, or can other factors explain Africa’s low score? This chapter assembles the key statistics allowing such a comparison as an essential starting point for policy discussion. The objective is not to belabor the shortcomings of Africa’s formal financial systems. Although there are sizable differences between countries within the region, it is well known that, on average, African finance performs well below that of other regions. Instead, the goal is to pinpoint especially weak areas and to identify dimensions in which improvements might realistically be hoped for.

—in both absolute and relative terms

As measured by aggregate banking depth, African financial systems are shallow. Most of this shallowness can be related to low income, given the worldwide tendency for higher-income countries to have deeper financial systems. However, a disproportionate number of African countries are

below this average relationship, especially in terms of credit. Offshore deposit accounts explain some of the missing deposits, and an apparent inability of banks to find enough safe lending opportunities shows up in the low credit numbers. Banking spreads are high too, as are bank profits and overhead costs. Lack of competition in banking is one aspect of this problem, and it can also be traced to other structural factors that have been shown to contribute to spreads in other countries.

Only one in three African countries has an organized securities market, and though South Africa has one of the largest emerging stock markets in the world, only a handful of the rest of the stock markets have achieved significant capitalization or liquidity. Insurance is also highly variable across African countries, especially in the life sector, with considerable potential both for development and, as with pension and social security funds, for more effective portfolio allocation.

Much of the financial sector is informal

Reflecting the prevalence of poverty in the region, new data suggest that not more than 20 percent of African adults have an account at a formal or semiformal financial institution. Across countries, however, the data vary widely, and the roles of different classes of institutions—savings banks, cooperatives, microfinance institutions (MFIs) sponsored by nongovernmental organizations (NGOs)—also vary widely. Enterprises complain more about lack of finance in Africa than in other regions, and they are less likely to use formal external finance, which impedes investment and growth.

Financial Depth and Efficiency: What Explains Africa's Low Score?

As for the developing world as a whole, banking is at the heart of Africa's formal financial systems, so measures of banking depth and efficiency are the natural place to begin.

Banking Depth

Banking depth is generally measured by reference either to deposit resources mobilized by the system or by credit extended. Although these two measures of depth are closely correlated, there are differences, both in

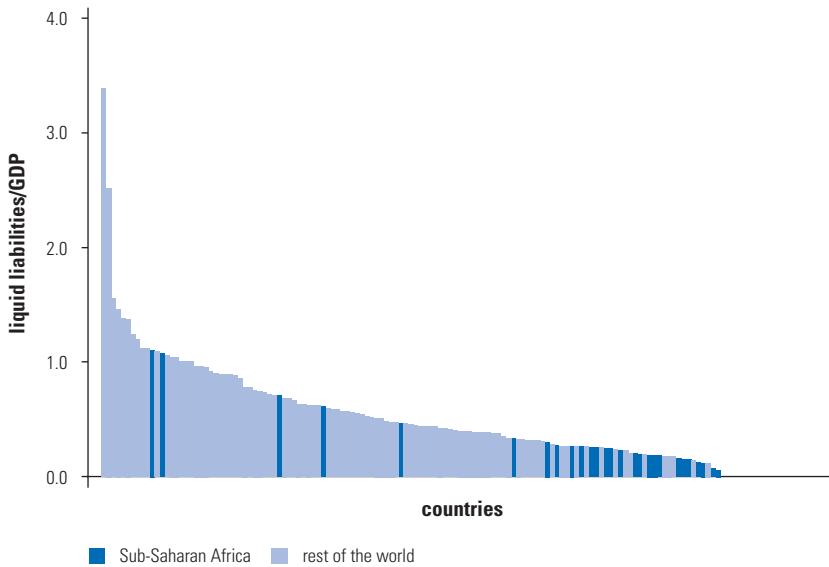
terms of their influence and in terms of measurement. The deposit side is central to analysis of monetary policy, inasmuch as it measures an important component of liquid spending power in the economy, and fluctuations in money and bank deposits may help predict inflation. But it is the level of bank credit to the private sector that is most closely correlated with medium-term growth and poverty reduction (Beck, Demirgüç-Kunt, and Levine 2004; Beck, Levine, and Loayza 2000; Honohan 2004), essentially because that measure captures the degree to which banks are channeling society's savings to productive uses.²

Deposit and credit measures differ for several reasons. In addition to mobilizing domestic deposits, banks can source loanable funds from the wholesale market—for example, from their affiliates or from other banks abroad. Furthermore, capital liabilities—owners' resources, for example—are also important contributors to a bank's capacity to lend. Conversely, not all the resources mobilized may be onlent to the domestic private sector. For one thing, the government and other public authorities and public enterprises will also be drawing on bank finance; furthermore, many banks invest some of their resources abroad.

We therefore focus on two standard indicators of financial depth and development: the ratio of liquid liabilities to gross domestic product (GDP) is a broad measure of monetary resources (currency plus demand and interest-bearing liabilities) mobilized by banks and near-bank intermediaries relative to economic activity. The ratio of private credit to GDP gets us closer to the growth potential of financial intermediation by measuring the claims of financial institutions in the private sector relative to economic activity.³

In interpreting the data, one must bear in mind that the link between financial depth and growth is a two-way one: although deeper financial systems tend to boost subsequent growth, the level of per capita income is also a major determinant of current financial depth, with lower monetary holdings in poor countries. Consistent with this relationship, we find that intermediary development in most African countries is lower than in other regions of the world (figures 2.1 and 2.2). The ratio of liquid liabilities to GDP averages 32 percent in Africa, compared with 49 percent in East Asia and Pacific and 100 percent in high-income countries. Similarly, the ratio of private credit to GDP averages 18 percent in Africa, compared with 30 percent in South Asia and 107 percent in high-income countries. The ratio of private credit to GDP averages 11 percent in low-income countries in Africa but 21 percent in low-income countries outside Africa.

FIGURE 2.1
Liquid Liabilities across Countries



Source: World Bank's Financial Structure database.

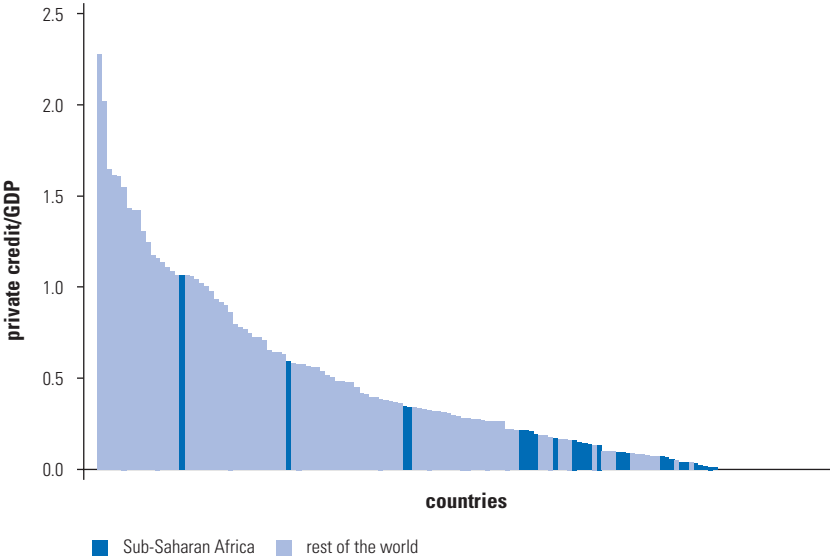
Note: This figure shows the liquid liabilities of the monetary system (M3) relative to GDP for the 127 countries available. African countries are shown in darker color. The highest African values are for the offshore financial centers of Seychelles, Mauritius, and Cape Verde, followed by those of South Africa and Ethiopia. All data are for the latest available year, 2004–05.

Within Africa, the tendency for higher-income countries to have deeper financial systems is also observed (figure 2.3). Consistent with its much higher mean income (and special economic structure), South Africa is a large outlier in all these indicators and need not be discussed further in this context. Two other outliers in the deposit data, Mauritius and the Seychelles, are offshore financial centers. An additional factor is inflation expectations; countries with long experience of inflationary surges tend to have lower monetary depth (Boyd, Levine, and Smith 2001).

Figures 2.4 and 2.5 show that much of the low level—and of the cross-country variation—in African monetary depth can be explained by national per capita income, controlling for inflation. Still, more African countries fall below the line than above it.⁴ Among the low-depth countries are all but one of the members of the CFA franc zone.⁵

Monetary depth is lowered by the tendency of wealth holders to hold their liquid assets outside Africa: the ratio of offshore deposits to domestic bank deposits is significantly higher in Africa than in other regions of the

FIGURE 2.2

Private Credit across Countries

Source: World Bank's Financial Structure database.

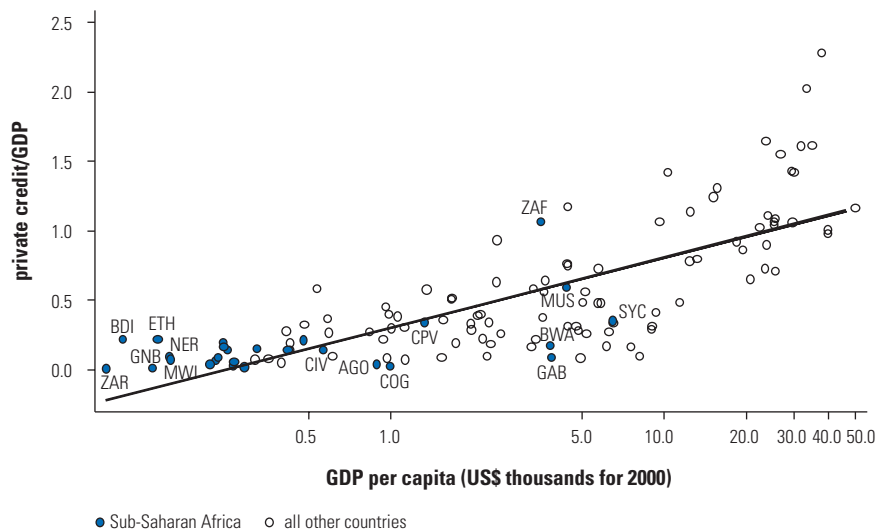
Note: This figure shows private credit granted by deposit money banks and other financial institutions relative to GDP for the 128 countries available. African countries are shown in darker color. The highest African values are for South Africa, Mauritius, Seychelles, and Cape Verde. All data are for the latest available year, 2004–05.

world (figure 2.6). This tendency points to capital flight as one factor exacerbating the low rate of domestic savings (though additional factors are at work, including the requirement imposed by some foreign financiers for African importers to post cash collateral abroad).⁶ Aggregate data point to Africa as the continent with the largest capital flight relative to private wealth, for which a variety of risk factors are likely causes (Collier and Gunning 1999a, 1999b; Collier, Hoefler, and Pattillo 2004; Ndikumana and Boyce 2002). Unlike in other regions, capital flight in Africa is not compensated by private capital inflows; Africa is the only region where donor funding still exceeds private portfolio funding (Senbet and Otchere 2006).

Also, in terms of credit depth, more African countries fall below what would be expected from the cross-country pattern—and in several cases the gap is quite large (figure 2.5). This feature is consistent with another striking characteristic of African financial systems: the low intermediation ratio (that is, the low share of deposits intermediated into private sector credit). Figure 2.7 shows what is happening: in Africa, the median bank-

FIGURE 2.3

Private Credit and GDP per Capita



Sources: World Bank's Financial Structure database; World Bank's World Development Indicators database.

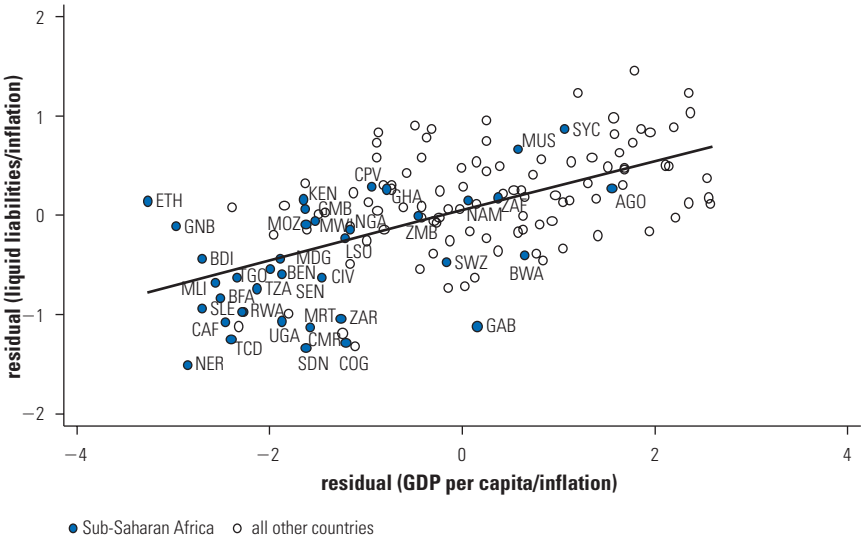
Note: Country abbreviations are included in the abbreviations list at the front of the book. This figure plots the ratio of private credit to GDP against GDP per capita (in log scale) for 122 countries. African countries are shown in darker color. All data are for the latest available year, 2004–05.

ing system allocates more of its resources to liquid assets and lending to government than do systems in other regions, thus implying a lower share of credit allocated to the private sector. Given the importance of private sector credit for economic growth, finding effective ways of ensuring that the banks channel more of their resources to the domestic private sector is crucial for financial sector development.

Though financial depth remains low, signs of recovery are unmistakable and encouraging. As figure 2.8 shows, indicators of financial development for the median African country have steadily increased over the past 10 years after hitting a low point in 1995–96. The earlier decline was partly a legacy of bank closures and rationalizations following the waves of banking failures experienced in earlier years. A cleanup of the books left private credit and deposits lower than they had been (and often saw a jump in the share of government credit when failing banks were recapitalized with government bonds). There was thus room for growth, which is now being realized.

FIGURE 2.4

Liquid Liabilities to GDP and GDP per Capita



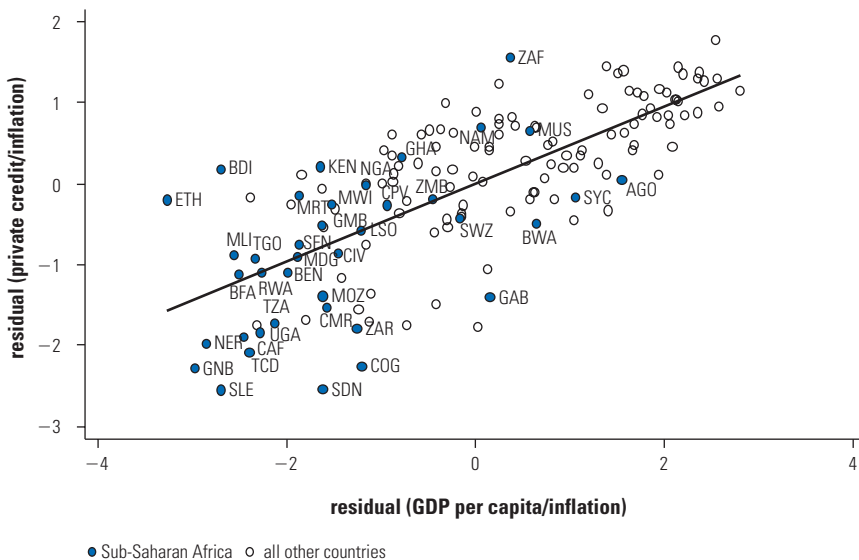
Sources: World Bank's Financial Structure database; World Bank's World Development Indicators database.

Note: Country abbreviations are included in the abbreviations list at the front of the book. This figure plots the residual from a linear regression of the ratio of liquid liabilities to GDP on inflation against the residual from a linear regression of GDP per capita on inflation for 139 countries. Liquid liabilities and GDP per capita are in log scales. African countries are shown in darker color. All data are for the latest available year, 2004–05.

Real private sector credit has, in particular, been growing at an accelerating rate, and its median value has doubled in the past decade. Even as a share of GDP, it has turned the corner, with the median share reaching almost 14 percent in 2005, about a third higher than at its anemic trough in 1996. (A regression estimate of the time trend is shown in figure 2.8.) And although some countries have not shared in the general upward movement, four of every five African countries for which data are available have seen financial depth increasing since 2000.

The continued wide variation in financial depth among African countries (map 2.1) shows considerable further upside potential, especially in countries such as the Democratic Republic of Congo and Mozambique, where private sector lending remains minuscule. A case in point is Tanzania, where the loan-to-deposit ratio of the banking system as a whole dipped to less than 18 percent after the financial restructuring of the largest banks. After a cautious resumption of lending, the ratio of private credit to

FIGURE 2.5
Private Credit to GDP and GDP per Capita



Sources: World Bank's Financial Structure database; World Bank's World Development Indicators database.

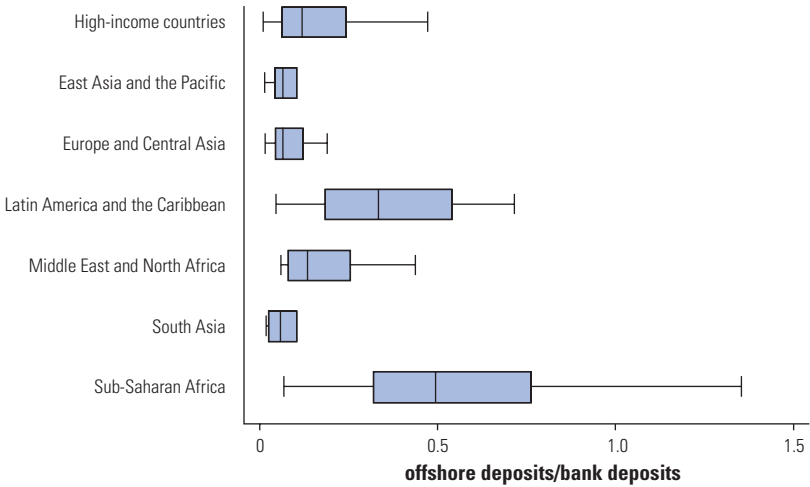
Note: Country abbreviations are included in the abbreviations list at the front of the book. This figure plots the residual from a linear regression of the ratio of private credit to GDP on inflation against the residual from a regression of GDP per capita on inflation for 151 countries. The ratio of private credit to GDP and GDP per capita is in log scales. African countries are shown in darker color. All data are for the latest available year, 2004–05.

GDP has increased steadily since 1996, growing from 2.8 percent in that year to about 10 percent by 2005. Tanzanian bank deposits have also been growing rapidly and these resources are still underlent: there is considerable growth potential left, even before considering the possibility of mobilizing more domestic resources. For Tanzania, as for other countries, the question remains how to unlock this growth potential.

Banking Competition and Efficiency: Interest Margins, Costs, and Profitability

Africa's banking systems are characterized not only by low levels of intermediation but also by high interest rates, wide intermediation spreads, and substantial bank profitability. High lending interest rates, whether caused by inefficiency or lack of competition, do more than add to borrowers' costs. By pricing the safer borrowers out of the market, high interest rates

FIGURE 2.6

Offshore to Domestic Bank Deposits: Regional Distributions

Sources: World Bank's Financial Structure database; Bank for International Settlements online database.

Note: For each region, the figure plots the minimum, maximum, and median of the ratio of offshore to domestic bank deposits for 132 countries. The shaded boxes show the interquartile range. Outliers have been omitted. All data are for the latest available year, 2004–05.

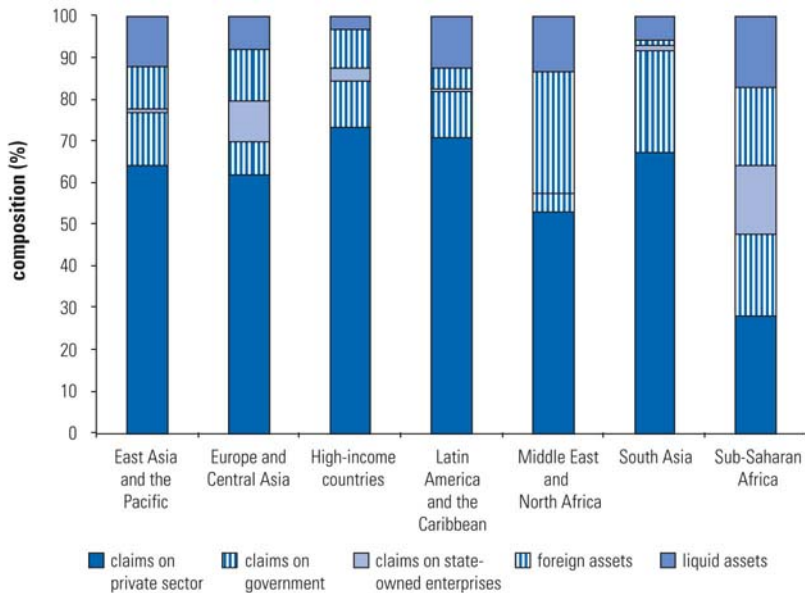
can increase the risk of lending, making banks less willing to lend and—as has been recognized since the pioneering work of Stiglitz and Weiss (1981)—potentially resulting in credit rationing combined with high bank liquidity. One source of high lending rates is high wholesale interest rates, which reflect currency and other macroeconomic uncertainties as well as the demand by governments for domestic loanable funds. The degree of efficiency and competition in the banking system is another factor that explains variation in lending rates.

Wholesale real interest rates in Africa increased significantly in the median African country in the early 1990s. This was a direct and intended consequence of interest rate and macroeconomic liberalization; it was also influenced by fiscal and macroeconomic expectation effects. Since 1993, realized wholesale interest rates have fluctuated without any discernible trend (figure 2.9).

Interest rate margins

The intermediation spread (the gap between average deposit and average lending rates) or the intermediation margin (net interest income as a per-

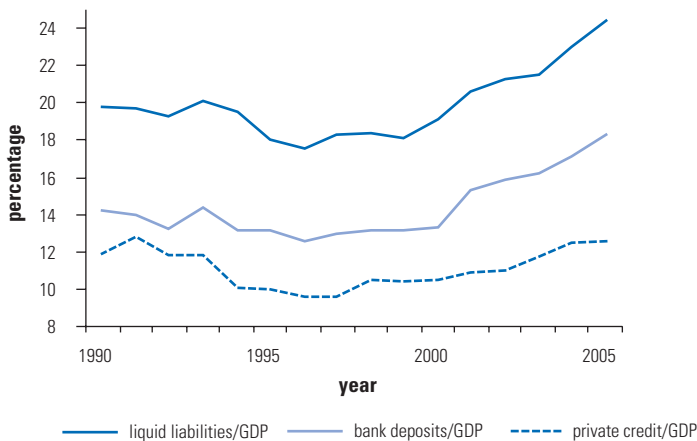
FIGURE 2.7
Asset Composition of Banks across Regions



Source: IMF's International Financial Statistics database.

Note: For each region, the figure shows the composition of the asset portfolio of banks between liquid assets, foreign assets, claims on state-owned enterprises, claims on government, and claims on the private sector. All data are for 2005.

FIGURE 2.8
Financial Depth in Africa, 1990–2005

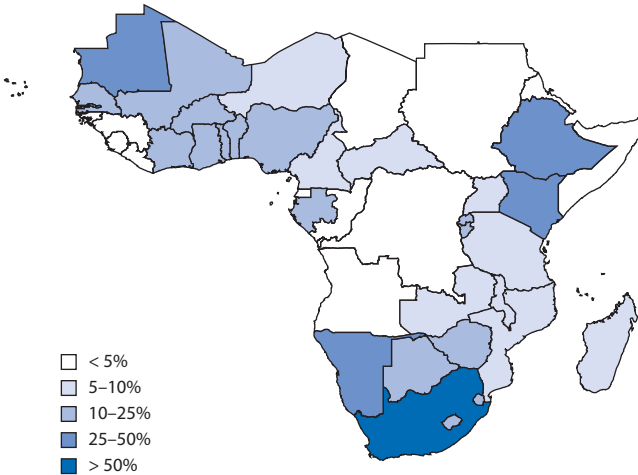


Source: IMF's International Financial Statistics database.

Note: Figure shows estimated date coefficients from pooled time-series cross-section median regressions.

MAP 2.1

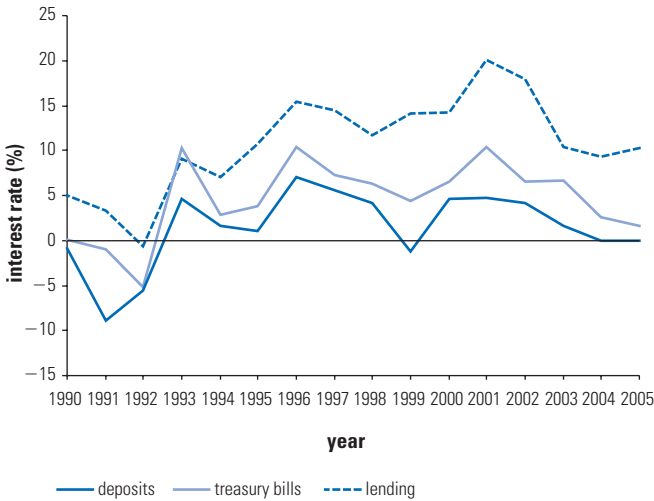
Financial Depth: Average Ratio of Private Credit to GDP, 2000–04



Source: World Bank Financial Structure database.

FIGURE 2.9

Real Interest Rates in Africa, 1990–2005



Source: IMF's International Financial Statistics database.

Note: The figure shows estimated date coefficients from pooled time-series cross-section median regressions. Real interest rates are computed using the consumer price index as the deflator.

centage of total earning assets) are often taken as measures of banking (in)efficiency. In interpreting these numbers, one must recall that the difference between interest received and interest paid by the banks goes to pay for staff and other noninterest costs and to make provisions for loan losses, as well as to contribute to profits. Thus, a high spread could result from an uncompetitive banking environment (implying higher profits) or from factors such as a higher risk of default. Some elements of default risk may in turn be considered systemwide and outside the control of the banks, but some banks may deliberately choose a high-yield, high-risk portfolio. Banks in some countries may also face different unit prices for skilled staff members and other inputs—though within a particular market variations in unit staff costs are likely to reflect skill differentials rather than exogenous factors. Foreign banks, however, often draw on expatriate staff members, which can increase intermediation costs considerably. Given all these considerations, it is clear that the variation across countries and across banks in intermediation spreads and margins needs to be interpreted with care.

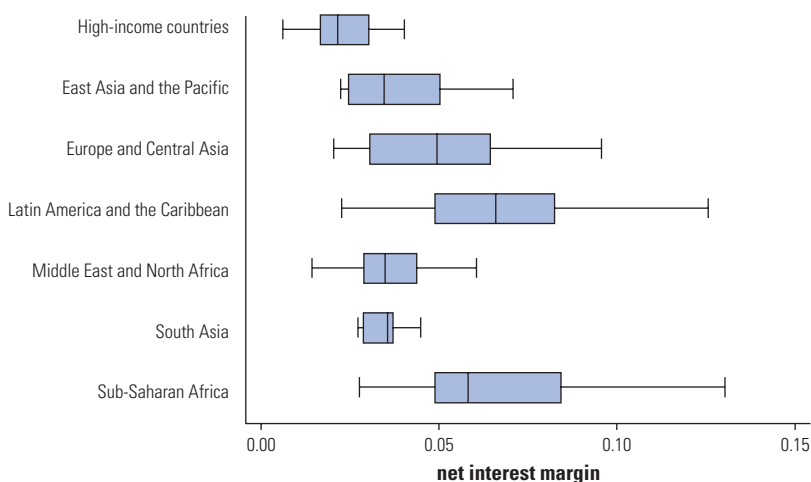
Figure 2.10 shows that African banking systems tend to have higher net interest margins than banks in many other parts of the world. On average, the net interest margin in African banks between 2000 and 2004 was 800 basis points, compared with 480 basis points in the rest of the world. However, banks in many Latin American and Eastern European countries have margins at least as high as African banks do, which raises the question of what drives high interest margins across banks and countries.⁷

One factor is bank profitability. The overall profitability of African banks in recent years has been high: in our sample, the average return on total assets was 2.1 percent, more than three times the profitability of non-African banks (0.6 percent). Similarly, the average return to equity for African banks in our sample was 20.1 percent over the period 2000 to 2004, compared with 8.5 percent for non-African banks (table 2.1). High profitability might be due to high risk premiums demanded by bankers, lack of competition, or—most likely—a combination and interaction of both.

Bank operating costs are another component of the interest margin.⁸ Mean operating costs—that is, administrative (overhead) costs—in African banks averaged 650 basis points during 2000 to 2004, compared with 480 basis points on average in the rest of the world.

Breaking down the interest margins into profit and cost components is informative but also raises a deeper question: what underlying structural

FIGURE 2.10

Net Interest Margins across Regions

Sources: World Bank's Financial Structure database; World Bank's World Development Indicators database.

Note: The figure shows the minimum, maximum, and median of the national mean net interest margins for banks in 146 countries, as reported in the BankScope database for the latest available year, 2004 or 2005. The shaded boxes show the interquartile range.

factors in the different economies are driving these differences? A recent study (Demirgüç-Kunt, Laeven, and Levine 2004), using bank-level data for 76 countries (including 7 from Africa) for the period 1995 to 1999 suggested that the most important drivers include the quality of property rights protection (weaker property rights lead banks to charge higher lend-

TABLE 2.1

Bank Profit Comparisons, 2000–04

	Return on assets (%)	Return on equity (%)
Africa	2.1	20.1
Foreign banks in Africa	2.8	26.7
Subsample of foreign banks in Africa	4.7	43.2
Rest of world	0.6	8.5
Foreign banks in rest of world	0.9	8.6
Subsample of foreign banks in rest of world	0.7	9.7

Source: Authors' calculations using data from BankScope.

Note: The table shows mean return on assets and return on equity for the classes of banks shown in Africa and in the rest of the world. The subsample of foreign banks consists of those banks for which data were available and that have operations both in Africa and in the rest of the world.

ing rates and also to spend more administrative resources on credit appraisal and monitoring); inflation; and bank size (smaller banks incur more overhead costs, which may also add to their interest margins).

Reestimating the same regression equation as in the 2004 study just mentioned with a larger and more recent data set allows us to obtain both confirmation and updated estimates of the importance of these underlying factors in contributing to higher operating costs and the other components of high interest margins. Table 2.2 shows the breakdown. Of the 320 basis points difference in average interest margin between Africa and the rest of the world, only 60 basis points are left unexplained by the model; of the 180 basis points difference in overhead costs, only 10 basis points remain unaccounted for. After we account for these different country and bank-level characteristics, a dummy variable for Sub-Saharan Africa does not enter either regression significantly. There seems to be no significant difference between margins and overhead costs across banks with different ownership structures, after controlling for other bank- and country-level characteristics.

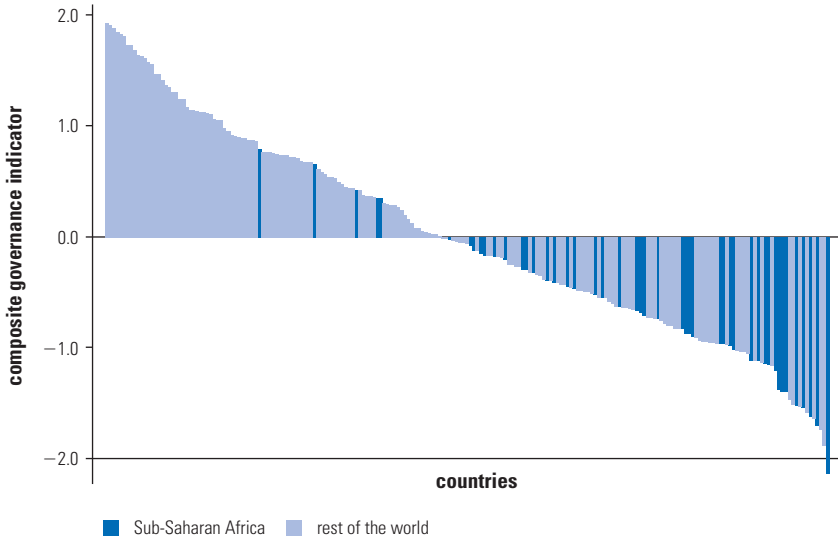
By this analysis, much of the gap, especially for the interest margin, is fundamentally explained by the weaker protection in Africa of property rights, as measured by the composite governance indicator for which recent values are plotted in figure 2.11. On a scale that has been normalized to give a worldwide average of zero and a standard deviation of one, the African countries in the sample have an average governance score of -0.5 . This lower governance score for Africa translates into a predicted dif-

TABLE 2.2
Net Interest Margins and Overhead Costs in International Comparison

	Interest margin (basis points)	Administrative costs (basis points)
African banks	800	650
Rest of world banks	480	480
Difference	320	180
Of which:		
Property rights protection	130	40
Bank size	70	50
Other bank characteristics	-40	70
Inflation	100	30
Africa residual	60	-10

Source: Authors' calculations using data from BankScope.

FIGURE 2.11
Governance across Countries



Sources: Kaufmann, Kraay, and Mastruzzi 2004; World Bank's Governance Matters IV database.

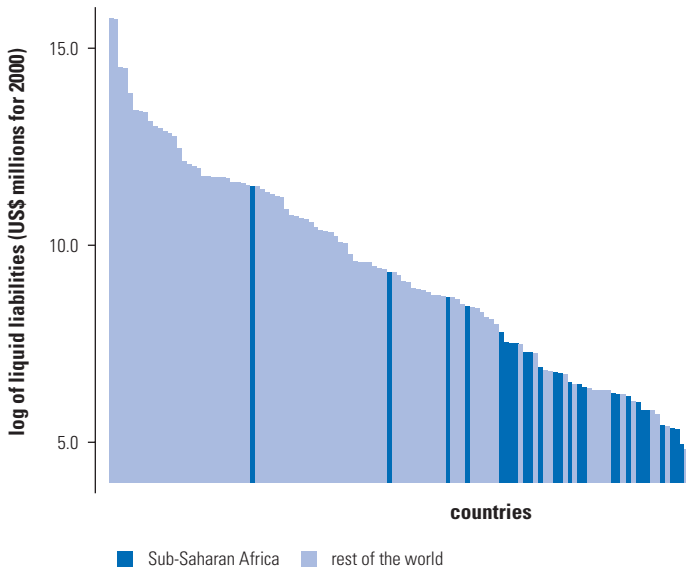
Note: The figure shows the composite governance indicator for 209 countries. African countries are shown in color. All data are for 2004.

ference of 130 basis points in the net interest margin differential and 40 basis points in the higher overhead costs. Although this indicator of governance is a very general one, the low score for Africa captures many aspects of an unsatisfactory contractual framework: weak creditor rights, seldom enforced by compromised courts; a deficient and rarely applied insolvency framework; and a general disrespect for contracts.

The small size of banks and financial systems in Africa can explain a large part of the large margins and overhead costs. The average African bank in our sample has total assets of US\$81 million, compared with US\$334 million for the average bank outside Africa. This difference can explain 70 basis points of the higher net interest margins and 50 basis points of the higher overhead costs in African banks, or about a quarter of the difference from the worldwide average. Small size is also reflected in the data on aggregate banking system size: African banking systems are among the smallest in the world (figure 2.12).

A number of bank-level characteristics are also important. Banks with higher fee income (as opposed to interest income) earn lower interest mar-

FIGURE 2.12

Size of Banking Systems across Countries

Sources: World Bank's Financial Structure database; World Bank's World Development Indicators database.

Note: The figure plots the overall size of the monetary system in 121 countries, as measured by liquid liabilities (M3) in U.S. dollars for all available countries, on a logarithmic scale. African countries are shown in color. The African country with the largest banking system is South Africa with US\$98 billion, followed by Nigeria with US\$11 billion, Mauritius with US\$6 billion, and Ethiopia with US\$5 billion. All data are for the latest available year, 2004–05.

gins but incur higher costs. Less liquid, better capitalized banks with more volatile earnings earn higher margins and incur high costs. On average, African banks' individual characteristics, other than size, tend to reduce interest margins but increase administrative costs.

Finally, monetary instability can explain a sizable part of the higher average net interest margins and overhead costs in Africa. Here differences between countries are especially substantial. Only 16 African countries have had annual average inflation in the double digits over the past decade, but the outliers—Angola and the Democratic Republic of Congo—have seen annual inflation running into the hundreds of percent, with Zimbabwe soaring above 1,000 percent per annum in 2005–06.¹⁰ As a result, cumulative inflation over the five years from 2000 to 2004 averaged 36 percent for African countries and 20 percent for the rest of the world. The high inflation boosted interest margins in the affected countries, explaining almost 100 of the 320 basis point average

difference in net interest margins and about 30 basis points of the administrative cost differences.

Some of the causal factors included in the regression estimates may have contributed to a lack of competition in African banking. Furthermore, the 60 basis points (on average) that remain unexplained may also be attributable in part to lack of competition. The same contractual and informational deficiencies that explain high overhead costs and high risk premiums in lending also reduce competitiveness by binding borrowers to specific lenders and by deterring new entrants.¹¹ These deficiencies also reduce the contestability of African banking by increasing entry costs for new institutions.

Most of Africa's banking systems are highly concentrated. This is not surprising, given the small size of the national markets. 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; for the median country, the figure is 74 percent. This figure compares with 60 percent for the world as a whole. No other region has a mean higher than 66 percent. The lowest ratios in Africa are for the largest economies—South Africa (41 percent) and Nigeria (48 percent).¹² All other African countries have ratios of at least 59 percent. The general picture is one of market dominance by a small number of banks. In Mozambique, the largest bank (a foreign-owned one) holds a 48 percent share in the lending market. In Mauritius, the largest two banks account for 77 percent of the lending market.

Concentrated banking systems are not necessarily uncompetitive—for example, in open systems, the threat of entry can restrain incumbents from overcharging (Claessens and Laeven 2004; Demirgüç-Kunt, Laeven, and Levine 2004). But concentration does often go hand in hand with market power, especially when contestability is weak.

This attempt at quantification of the obstacles to banking efficiency thus points to at least three major background dimensions: the contractual and informational environment, the broader issues of systemic risk, and the lack of scale. Together these dimensions can explain the high risk premiums demanded by bankers, the high profitability, and the lack of competition. The specific indicators used in the regression analysis only scratch the surface of these issues.

As can be seen in figure 2.9, the median quoted intermediation spreads (the gap between representative lending and deposit rates reported in the

International Monetary Fund [IMF] International Financial Statistics database) widened in the early 1990s—a trend that is likely attributable in part to liberalization. Since the late 1990s, the upward trend has been stabilized and even reversed, with the median for 2005 at about 1,000 basis points—compared with more than 1,500 basis points in 2001. The data are too noisy to point unambiguously to the explanation for this improvement, but one plausible explanation is that, as in other parts of the world, postliberalization competitive pressures have begun to kick in. Improvements in the underlying environmental factors discussed above will also have played their part, in countries such as Nigeria and Tanzania, for example.

Ownership issues

Following a wave of privatization and restructuring of banks—including state-owned ones—in numerous African countries, the balance of ownership has shifted dramatically in recent years. Now the foreign banks are back in force. Although somewhat similar trends have occurred in other parts of the world, the process has gone further in Africa than in other regions. Table 2.3 classifies countries according to whether their banking systems are mainly foreign owned (more than 60 percent of banking assets in foreign-controlled banks), mainly government owned (or owned by government agencies), mainly owned by the local private sector (with the same 60 percent dividing line), or foreign plus government owned (the two types accounting for at least 70 percent) or whether they fall in a residual category called “equally shared.” Two of every five African banking systems are mainly foreign owned, and only three countries (7 percent) are still dominated by state-owned banks. Map 2.2 shows the variation in ownership structure across African countries.

Interestingly, although a worldwide sample of banks shows no significant difference in profitability across banks with different ownership structures, foreign-owned banks in Africa are more profitable than foreign-owned banks elsewhere (even controlling for the higher profitability of banking in Africa). They are also more profitable than locally owned banks (see table 2.1). Table 2.1 also shows data for a subsample of banks with operations both in Africa and elsewhere. For this subsample, the difference between profit performance in Africa and elsewhere is even more pronounced: a mean of 9.6 percent in Africa as against 6.2 percent elsewhere.

TABLE 2.3

Distribution of African Countries by Predominant Form of Bank Ownership

Mainly government	Mainly foreign	Mainly local private sector	Foreign plus government	Equally shared
Eritrea	Botswana	Benin	Burkina Faso	Angola
Ethiopia	Cape Verde	Mali	Congo, Dem. Rep. of	Burundi
Togo	Central African Republic	Mauritania	Sierra Leone	Cameroon
	Chad	Mauritius		Congo, Rep. of
	Côte d'Ivoire	Nigeria		Gabon
	Equatorial Guinea	Rwanda		Ghana
	Gambia	Somalia		Kenya
	Guinea-Bissau	South Africa		Rwanda
	Guinea	Sudan		Senegal
	Lesotho	Zimbabwe		
	Liberia			
	Madagascar			
	Malawi			
	Mozambique			
	Namibia			
	Niger			
	Seychelles			
	Swaziland			
	Tanzania			
	Uganda			
	Zambia			

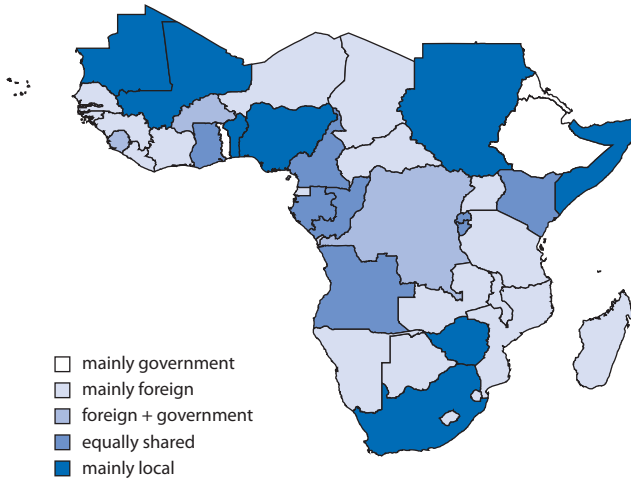
Source: World Bank staff estimates.

Note: *Mainly government*, *mainly foreign*, and *mainly local private sector* mean more than 60 percent of total assets are held by banks majority owned by government, majority owned by foreign shareholders, or majority owned by the local private sector, respectively; *foreign plus government* means these two categories together hold more than 70 percent. *Equally shared* is a residual category. (In Senegal foreign plus private local adds to more than 70 percent.)

Volatility

Monetary volatility is only one dimension of a generally volatile political and economic environment that has hampered monetary deepening and efficiency improvements. Africa is a continent of civil strife and political violence; only nine countries have suffered no internal or external conflict during the past 50 years (Strand and others 2004). On average, an African country survives little more than a decade without a major economic, social, or political disturbance (Arnold 2005; Meredith 2005). This duration is similar to 19th-century business cycles in what are now advanced economies—though the African crises tend to be deeper and more protracted and extend to all parts of the economy and society. Such volatility does not affect only financial depth and interest rate spreads. Just as the

MAP 2.2

Predominant Form of Bank Ownership

Source: World Bank Staff estimates.

business cycle impeded investment and growth in economies in the 19th century, so the likelihood that an investment in recent decades would be destroyed or made valueless by a major downturn must have impeded investment in Africa—chaining African business leaders to a short-term perspective.

The causes of these recurrent crises have been many. Part of the problem has been Africa's economic dependence on exports of primary products. The high share of natural resources and agricultural commodities in Africa's exports, combined with the high price volatility for these commodities, exposes African economies to high terms-of-trade volatility. Drought, floods, and other supply shocks add to the problems: natural disasters causing death occur frequently in Africa, as they do in much of mainland Asia. HIV/AIDS has often been mentioned as a cause in recent years. But it is the relatively high frequency of political disruption and civil strife that has most marked Africa for a seemingly endemic pattern of systemic economic instability.

Market perceptions of instability dampen financial sector development. Lack of financial development could also be contributing to the sources of instability in a variety of ways. For example, African countries lack diver-

sified financial instruments that could broaden claims on the prosperity that could be generated by a growing and profitable business sector. This in turn represents a missed opportunity to give a wider group of influential Africans a stake in sustained economic growth. Such participation in sustained economic growth, in turn, would help shift the focus of the elites' personal and political activities away from short-term thinking.

BOX 2.1

Historic Explanations of Cross-Country Variation in Financial Development

Although current policy and institutional conditions explain much cross-country variation in financial development and efficiency, scholars have sought to uncover past causal factors, notably in terms of the origins of legal structures, of geographic endowments, and of ethnic mix. Variations across African countries provide much of the evidence and, as such, are at the center of the debates on the relative importance of each factor.

The law and finance literature points to legal tradition as a decisive factor forming contractual frameworks, which are fundamental to financial sector development. The main divide is between the English Common Law and the French Civil Code traditions, and in particular the degree of protection each provides to private property rights and their adaptability to change. At the risk of caricature, it may be said that the evolution of Common Law was strongly influenced by the attempt to protect private property rights against the state, which facilitated the ability of private parties to transact confidently with each other and the state. The Civil Code tradition reflected the reaction to a corrupt and secretive prerevolutionary judiciary that had sided with rich property holders against reformist politicians; it thus has its origin in the state's attempt to solidify state power over private citizens. Where the Civil Code tradition distrusts judges and jurisprudence and thus relies on rigid bright-line rules, the Common Law tradition allows more dynamism as judges react to changing circumstances on a case-by-case basis, enabling the law to adapt quickly to the needs of the economy and especially

(Box continues on the following page.)

BOX 2.1 (*continued*)

the financial system. The Common Law tradition spread throughout the world with British colonizers; the Napoleonic Code influenced subsequent codifications in other colonizing nations, such as Belgium, Portugal, and Spain.

Map 2.3 shows the variation in legal origin across Africa. Consistent with the stronger protection of property rights and the prediction of dynamism, Common Law countries have higher levels of financial development than do Civil Code countries. This holds true not only for a broad sample of former colonies, but also within Africa—though here the difference is less pronounced and the variation across countries much larger within legal families (figure 2.13).

The law and finance view focuses on the identity of the colonizer. The endowment view has focused on the conditions that colonizers found when they arrived and the influence those conditions had on the behavior of the colonial powers (Acemoglu, Johnson, and Robinson 2001). Specifically, European settlers adopted different colonization strategies depending on whether the disease conditions were friendly to European settlement. Where conditions were conducive to settlement, settlers chose to recreate governance structures to support their private property rights and local market exchange. Where conditions were less friendly for settlement, the European colonizers created “extractive colonies,” establishing institutions that empowered colonizers to extract natural resources without protecting local business interests (Austen 1987). Congo, which was—in effect—the personal property of King Leopold I of the Belgians for a quarter-century, is often quoted as prime example of such an approach. Critically, these contrasting institutional structures survived the move to independence (Arnold 2005; Meredith 2005).

Nonbank Finance

The remainder of the formal financial system controls far smaller resources. This characteristic again is typical of low-income countries in general and not specific to Africa. But there is quite a lot of variation among African countries, revealing the potential for improvement in those that lag.

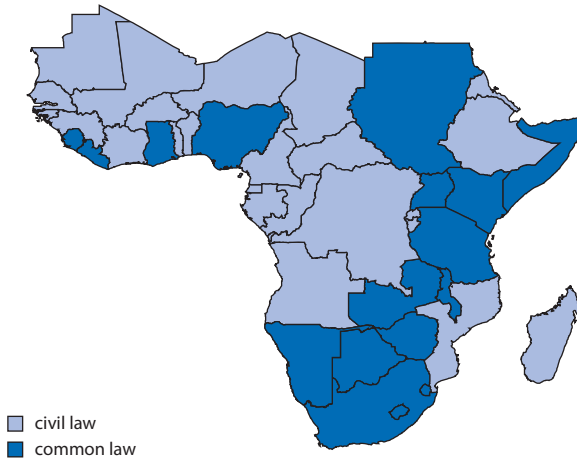
To capture a quantitative indication of the initial colonial conditions, scholars have used historical records on the death rates of early colonial settlers. Interestingly, as shown in figure 2.14, financial depth today is negatively associated with those early death rates. Within Africa, there is considerable variation in the early mortality rates: western African countries such as Ghana and Congo had very high mortality rates, whereas Kenya and Zimbabwe, for example, had low mortality rates—which were conducive to European settlement. This variation is also reflected in the levels of financial development. The choice of institutional structure is not solely caused by climatic conditions, though: Nunn (2005) notes that the incidence of slavery is also highly correlated with subsequent institutional development.

Under some conditions, ethnic diversity may produce a governing ethnic group that uses the state's powers to strengthen its dominance by restricting the rights of other groups and expropriating their resources, as well as impeding the growth of industries and sectors that will threaten the governing ethnic group. Such behavior could lead to rent seeking, inefficient and reduced allocation of public goods and services, and growth-reducing policies such as financial repression. In studies of this conjecture, diversity is measured by the so-called ethnic fractionalization index, which is the probability that two randomly selected people will not be members of the same ethnic group. African countries tend to have the highest scores on this index. However, though there is some econometric evidence that ethnic diversity could contribute to low growth in Africa (Easterly and Levine 1997), there is little evidence that it affects financial development in particular. The same is true of an alternative indicator of precolonial conditions, namely political centralization, which has been shown to be positively correlated with the provision of public goods in Africa (Gennaioli and Rainer 2005). For more detail and references to the literature, see also Beck and Levine (2005) and Levine (2005).

Nonbank financing can offer a range and variety of services that are not part of the standard product range of banks. Furthermore, a strong non-bank sector can also provide competition for banks. Financial systems in the advanced market economies are characterized by a very diverse array of institutions and markets offering a variety of products. Apart from banks, this array includes capital markets, with both equity and debt securities and contractual savings institutions, such as insurance companies,

MAP 2.3

Common Law and Civil Code Countries



Source: World Bank staff judgment.

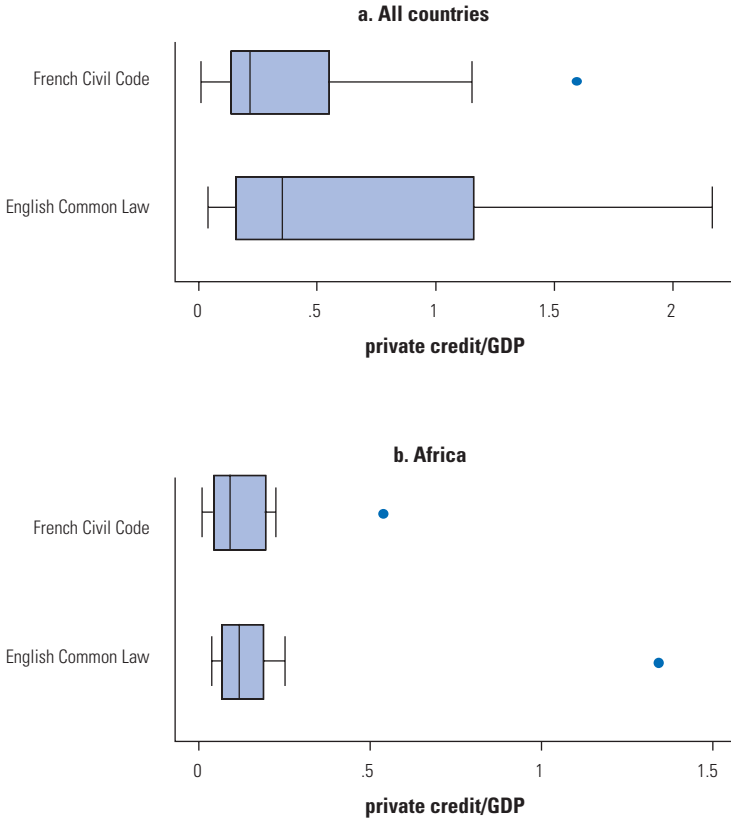
pension funds, and mutual funds. This wider range of institutional specializations has the potential to offer a wider range of financial services and better risk pooling, at better prices, in a more competitive environment than is characteristic of the bank-dominated systems observed in most of Africa and in most low- and lower-middle-income countries around the globe. In particular, contractual savings institutions can be major forces in providing patient capital, in equity or loans, for long-term projects. Organized securities markets help to improve the transparency of funding arrangements by determining the market-clearing price of equities, as well as market-clearing interest rates for bonds. Equity markets are particularly valuable for providing financing to risky ventures, about which there may be wide differences of opinion: banks are often reluctant to finance such ventures because the downside risk is insufficiently compensated by the contractual interest rate; well-resourced investors can build a portfolio of equity claims on such ventures for which the securities market will provide an exit mechanism, in due course, for those that are successful.

Securities Markets

With a market capitalization of US\$600 billion, the South African (Johannesburg) market is the fourth-largest emerging market in the world (after

FIGURE 2.13

Private Credit: French and English Legal Origin



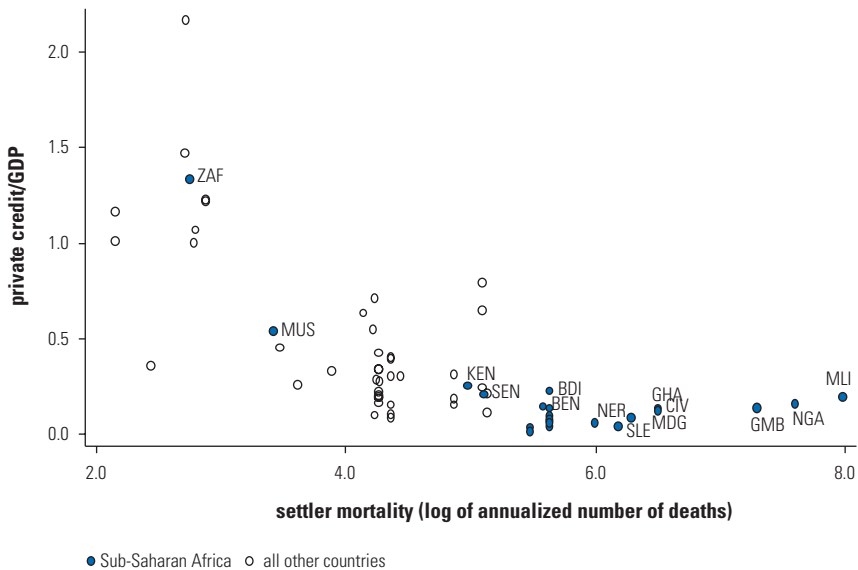
Source: World Bank's Financial Structure database.

Note: The figure shows the minimum, maximum, and median of the ratio of private credit to GDP for 84 countries of the world (panel a) and for 26 countries in Africa (panel b). The shaded boxes show the interquartile range. All data are for 2005.

those in the Republic of Korea, the Russian Federation, and India and before those in Brazil, China, and Hong Kong, China). Yet even Johannesburg is not a big enough market to retain the primary listings of several of South Africa's largest companies. Twenty-one companies listed in Johannesburg have their primary listings elsewhere—including the mining conglomerate Anglo American, the banking group Investec, the brewing company SAB-Miller, the insurance giant Old Mutual, and the technology company Dimension Data, all of which have their primary listings in London. This list shows that the context in which African securities markets operate is one in which the larger companies look abroad as well as to the home market.¹³

FIGURE 2.14

Financial Development and Initial Colonial Conditions



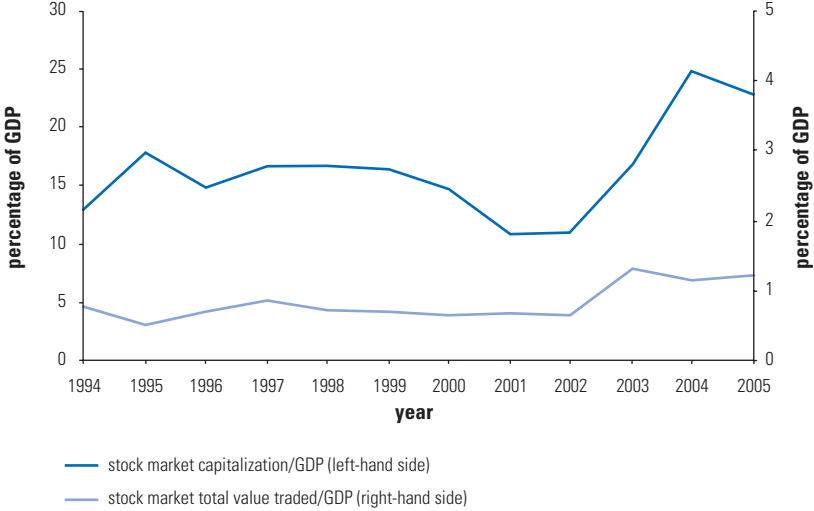
Sources: Acemoglu, Johnson, and Robinson 2001.

Note: Country abbreviations are included in the abbreviations list at the front of the book. The figure plots financial depth in 63 countries, as measured by the ratio of private credit to GDP against an index of colonial settler mortality (log of the annualized number of deaths per thousand). African countries are shown in darker color. All data are for 2004.

Africa has 15 organized securities markets. Several other projects are under discussion or partly implemented, but not yet active. (This number does not include Cameroon and Gabon, both of which recently established stock exchanges but have not yet attracted any listings.) One exchange, the Bourse Régionale des Valeurs Mobilières (BRVM) headquartered in Abidjan, caters to the eight-country Union Economique et Monétaire Ouest Africaine (UEMOA). The BRVM was expanded from the Abidjan stock exchange created in 1976. Four other exchanges started operations in the days of the British Empire: those with headquarters at Nairobi, Lagos, Harare, and Johannesburg, the last two having histories going back into the 19th century. The older exchanges also have the largest number of equities listed. These five, along with those established in 1988 and 1989 in Botswana, Ghana, and Mauritius, were the only exchanges with market capitalization at the end of 2004 in excess of 10 percent of GDP, even though market capitalization has been increasing in recent years (figure 2.15).

FIGURE 2.15

African Stock Exchanges: Capitalization and Value Traded as a Percentage of GDP



Source: Compiled from published stock exchange reports.

Note: The figure shows the medians of the eight most active exchanges by value traded other than Johannesburg (that is, for Botswana, Côte d'Ivoire, Ghana, Mauritius, Mozambique, Namibia, Nigeria, and Zimbabwe).

Trading data show a different aspect of the contribution of stock exchanges in developing countries. That contribution is influenced by secondary market liquidity and also by the degree to which a large fraction of the shares in developing markets is effectively locked up in the strategic stakes of controlling shareholders and not normally available for trading. It should be noted in this context that funds actually raised on these markets—as on most capital markets¹⁴—are but a tiny fraction of market capitalization. The eight oldest exchanges also have the most active trading, with the value traded fluctuating around 2 percent of GDP for the past several years (table 2.4; see also figure 2.15). Yet even these more active African exchanges (Johannesburg aside) cannot be considered to have much trading. Except for Johannesburg, turnover on all markets is less than 15 percent of market capitalization. There was no trading on the Maputo exchange in 2004.

Low turnover is reflected in and feeds back onto a lack of liquidity, as illustrated by large gaps between buy and sell orders and high price volatil-

TABLE 2.4
Stock Exchanges in Africa

Country	Number of listed firms	Market cap (% of GDP)	Value traded (% of GDP)	Turnover (%)	Zero-return weeks (% of total)	Concentration of firms	Number of listed corporate bonds	Year established
Botswana	25	27.2	0.6	2.1	—	0.21	17	1989
Côte d'Ivoire (BRVM)	39	12.3	0.3	2.5	—	0.21	—	1976
Ghana	30	23.7	0.8	3.2	70	0.12	3	1989
Kenya	47	26.1	2.1	7.9	41	0.20	—	1954
Malawi	8	9.2	1.3	14.1	—	—	0	1996
Mauritius	41	36.0	1.6	4.4	48	0.12	1	1988
Mozambique	1	3.0	0.0	0.0	—	—	—	1999
Namibia	13	6.9	0.3	4.7	57	0.39	4	1992
Nigeria	207	16.7	2.3	13.9	67	0.08	—	1960
South Africa	403	170.5	76.5	44.9	13	0.06	—	1887
Swaziland	6	8.3	0.0	0.0	—	—	2	1990
Tanzania	6	6.2	0.2	2.5	—	—	6	1998
Uganda	5	1.4	0.0	0.2	—	—	—	1998
Zambia	13	8.0	0.1	1.5	—	—	0	1994
Zimbabwe	79	41.3	2.9	7.0	37	0.08	—	1896

Sources: World Bank's Financial Structure database; World Bank's Financial Sector Development Indicators database.

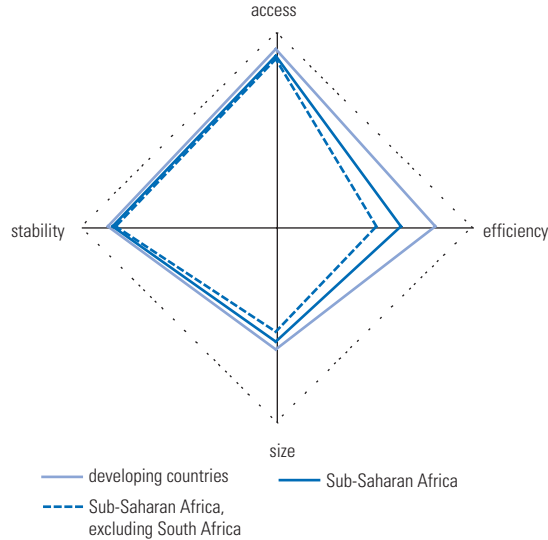
Note: — = not available. All data are for 2005, except for Malawi, for which data are from 2002, and zero-return weeks, for which data are for 2000–04. Zero-return weeks measure the average over all companies of the percentage of weeks for which there was no price change; this measure indicates illiquidity. Concentration of firms is measured using the Herfindahl index of the market capitalization of listed firms. Secondary listings are not included; for example, data for Malawi exclude the Old Mutual cross-listing.

ity. This lack of transactions is also somewhat self-reinforcing, as the transaction volume does not justify investment in technology either by the exchange itself or by member brokers. Limited trading discourages listing and raising money on the exchanges. Even linking different centers electronically (as in the BRVM or in Namibia, whose exchange is now electronically linked to the Johannesburg exchange) cannot guarantee much more trading and liquidity.

In international comparisons of composite indicators of equity market development (data are available typically only for seven or eight of the African exchanges), it appears that the main African exchanges fall behind the average in developing countries, mainly in regard to efficiency, as distinct from size, stability, and access of issuers (figure 2.16).¹⁵ The other seven markets, all established since 1989, are small by all measures. The smaller African countries tend to have neither organized exchanges nor any prospect of one.

FIGURE 2.16

International Comparison of Stock Exchange Development: Main African Exchanges Relative to Other Developing Countries



Source: World Bank's Financial Sector Development Indicators database.

Note: The figure shows the mean performance of different groups of exchanges relative to exchanges in high-income countries. Developing countries as a whole have much smaller exchanges than do high-income countries, but it is mainly in their efficiency that African exchanges fall short of the performance of other developing market exchanges. The composite indicators are defined in World Bank (2006).

The small size and illiquidity of Africa's stock exchanges partly reflect low levels of economic activity, which make it hard to reach a minimum efficient size or critical mass, and partly reflect the state of company accounts and their reliability. Several of the exchanges established in the late 1980s and 1990s were set up mainly to facilitate privatization, in the hope of attracting inward investment with the modernization and technology transfer that such investment could convey (Moss 2003). For example, the stock exchange in Maputo was established in the process of privatizing Mozambique's national brewery, which is still the only listed company and which must bear the operating costs of the stock exchange. To the extent that the establishment of stock exchanges was driven by outside influences—rather than emerging from a realistic need felt in the market, whether by investors or by issuers—it is perhaps unsurprising that many have so far struggled to reach an effective scale and activity level.

Pricing on all the markets appears to build in a sizable risk premium, to judge, for example, from the low price-earnings ratios that have been prevalent (Moss 2003; Senbet and Otchere 2006). The widespread limitations on foreign holdings of listed shares, although diminishing in recent years, have also contributed to low prices.¹⁶ High risk perceptions affect all countries, even those with stable macroeconomic environments; indeed, most countries lack sovereign credit ratings. The perceived risk is reflected also in the very small amount of funds raised through new issues, including initial public offerings (IPOs) and other public sales of equities.¹⁷

Nevertheless, issuing activity has picked up. Ghana had five new equity issues in 2004, accounting for US\$60 million. The Kenya Electricity Generating Company (KenGen) IPO of 2006—the country's first in five years—attracted strong demand and enormous public interest, raising more than US\$100 million.¹⁸ In Nigeria, the equivalent of almost US\$3 billion in new capital was raised on the exchange in 2003 to 2005 in connection with the new capital requirements for banks.

Scale issues in equities have been mirrored in the bond market; only a limited number of private bonds have been listed, and there is little secondary market trading. In Tanzania capitalization of corporate bonds amounts to T Sh 89 billion (about US\$90 million); compare that with equity market capitalization of T Sh 2.3 trillion. Ghana has three corporate bonds, but 30 listed companies. The bond market capitalization of the BRVM is relatively higher—about one-fifth of equity market capitalization. Most of the larger issues are governmental or from government-owned enterprises, and trading is very light.

African governments¹⁹ have relied more on foreign debt than on domestic debt, though about half have issued significant domestic debt instruments (not all of them traded on an organized market), eight with domestic debt-to-GDP ratios in excess of 20 percent. Banks tend to be the biggest holders, with about two-thirds of the stock outside the central bank. With an estimated 87 percent of the debt having initial maturities of 12 months or less, there is little secondary trading (Christensen 2004). Longer-term issues have only recently appeared (or reappeared) on some of the exchanges. The 7- and 10-year issues of the regional development banks Banque Ouest Africaine de Développement (BOAD) and East African Development Bank (EADB) are noteworthy, together with a handful of government and corporate bonds. The absence of such issues in most currencies means a lack of good reference rates for long-term finance (Irving 2005).

Insurance, Pension, and Collective Savings Institutions

Insurance penetration is low across Africa with the notable exception of a few countries in southern Africa, presumably reflecting the persistence in that subregion of factors that account for the traditional success of this subsector in the United Kingdom in colonial times (that is, factors that are partly tax driven). Most countries have insurance penetration ratios (premium volume relative to GDP) of less than 1 percent. Low income explains much of the low insurance penetration, with monetary instability and weak contractual frameworks also contributing. In most countries, insurance is characterized by many small and weak institutions and inadequate supervision.

Some countries have introduced a funded national social security system and funded pensions for public servants; where these funds exist, they are in an accumulation phase. Although actuarial valuations of several of these schemes raise questions about their long-run sustainability in the absence of a change in parameters, for the medium term they will be increasingly important suppliers of investable funds. To date, however, most insurance companies and pension funds have invested mainly in real estate, government securities, and bank deposits and comparatively little in equities and corporate bonds (table 2.5).

TABLE 2.5
Portfolio Composition of Selected Life Insurance and Pension Funds

Country	Fund	Cash, deposits, and so forth (%)	Government paper (%)	Equities (%)	Real estate (%)	Other (%)	Date
Ghana	Social Security and National Insurance Trust	8.0	7.2	19.4	35.0	30.4	1999
Ghana	Insurance	21.0	14.2	5.0	14.8	45.0	1999
Kenya	Insurance	8.2	30.5	7.0	29.0	25.3	2001
Kenya	National Social Security Fund	7.3	2.0	10.9	68.8	11.0	2002
Nigeria	Life insurance	12.2	3.9	31.3	11.1	41.5	1999
Senegal	Life insurance	30.9	12.7	25.0	8.5	22.9	1999
Senegal	IPRES (public pension fund)	81.8	8.6	9.6	0.0	0.0	2000
Tanzania	National Social Security Fund	26.0	25.0	6.0	24.0	19.0	2002
Tanzania	Parastatal Pension Fund	34.0	7.0	7.0	37.0	15.0	2002
Uganda	National Social Security Fund	41.9	11.3	8.2	34.8	3.8	2000

Source: World Bank files. Data are for different years over the period 1999 to 2003.

Term Finance

Another striking characteristic of financial systems in Africa is the concentration on short-term claims across all financial institutions and financial markets. This characteristic is exemplified by the dominance of short-term rather than long-term government paper. Christensen (2004) found that the average maturity of government paper in 15 African countries was just 231 days. Four of those countries had average maturities of less than four months, compared with five and one-half years for developed countries. This lack of long-term government financing can be explained by reluctance on both sides of trading. Undoubtedly, given the systemic volatility already discussed, providers of funds are more comfortable with an arrangement in which they can decide whether to renew short-term advances on the basis of evolving conditions. Even if borrowers could secure long-term funding, it would be at unfavorable terms. This concentration on the short-term end is matched in private sector lending and on the deposit side. In Mozambique, only 35 percent of the local-currency loan portfolio and 28 percent of the foreign-currency loan portfolio have an original maturity of more than one year. In Uganda, 35 percent of the loan volume has an original maturity of more than one year, which is concentrated in 12 percent of all loans and mostly financed through donor lines of credit. A similar picture can be observed on the deposit side. In Uganda, only 0.4 percent of time deposits have an original maturity of more than a year.

Limited evidence from users, however, does not paint as bleak a picture. Firm-level surveys suggest that firms' bank loans have the same, if not longer, terms as bank loans in other regions. The average firm in the median African economy reports bank loans with maturities of 45 months, compared with 36 months in South Asia, 40 months in Latin America, and 52 months in high-income countries.

Illustrative of the limited availability of term finance is the lack of housing finance in most African economies. Although the stock of housing finance in Namibia and South Africa comes to 18 to 20 percent of GDP, the figures for other countries for which data are available are no more than 2 percent (Mali, Rwanda, Senegal) or even 1 percent (Ghana, Tanzania, and Uganda).²⁰ This figure is not only small in relation to GDP but also as a percentage of total private credit. In addition to the general confidence factors that have worked against the growth of term finance, many specific factors impede expansion of mortgage credit, including lack of effective title and

collateral registration systems. Attempts by many African governments to address the dearth of housing finance over the years with government-owned housing finance intermediaries resulted in skewed allocations of subsidies to a small number of well-connected borrowers. As with other state-owned development finance institutions (DFIs), many of these institutions eventually became insolvent and had to be bailed out—as in Côte d’Ivoire, Niger, Rwanda, Tanzania, and elsewhere.

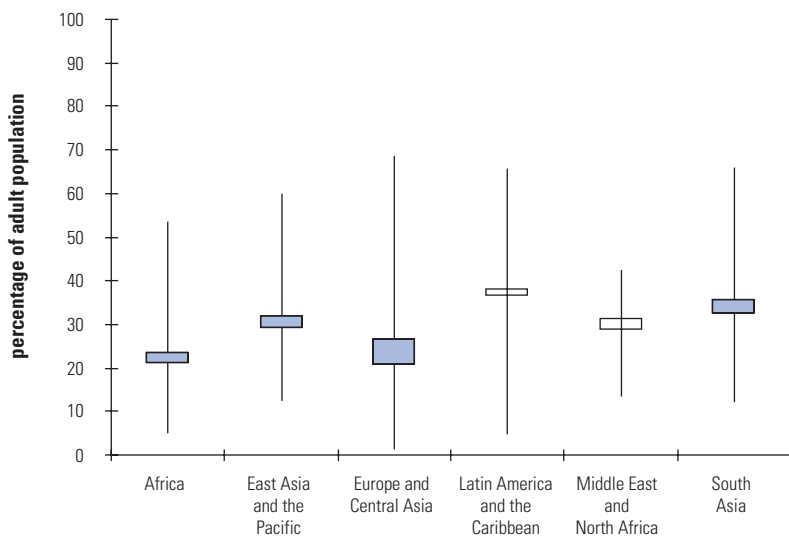
Inclusive Household Finance

The financial service needs of lower-income households in Africa—which have long been excluded from the formal financial system—have begun to receive more attention from governments, NGOs, and even banks. The accelerating expansion of formal and semiformal microfinance and the political changes in South Africa have been major factors in this change.

Although the closure of some state-owned banks with broad outreach may have reduced households’ financial access in some countries, microfinance has grown. Taking account also of the continued effectiveness of some post offices as suppliers of banking services and piecing together available information make it possible to generate rough estimates of the percentage of the adult population with a bank or banklike account. In the median African country, the figure is less than 20 percent. This percentage is lower than in other regions, but the gap is, perhaps, smaller for this dimension than for other aspects of finance (figures 2.17 and 2.18).²¹ To a significant extent, the low access percentages reflect general economic conditions (per capita income can explain a high fraction of the variation in access across countries). However, African access figures remain about 2 percentage points lower on average, a figure that is not statistically significant.

Mapping the estimated access percentages shows how widely access varies (map 2.4). In addition to relatively high percentages in Botswana, Mauritius, and South Africa, the estimated access percentages are relatively high in Angola, Benin, Gabon, and Niger, as well as in Zimbabwe. Several of the largest financial intermediaries in terms of numbers of clients are post office savings banks (even allowing for the fact that some accounts may be dormant). Although not all have been continuously effective over their lengthy histories, there have been successful turnarounds, and they remain very important in the market for small deposits and payments services.

FIGURE 2.17

Access to Finance, Regional Extremes, Medians, and Means

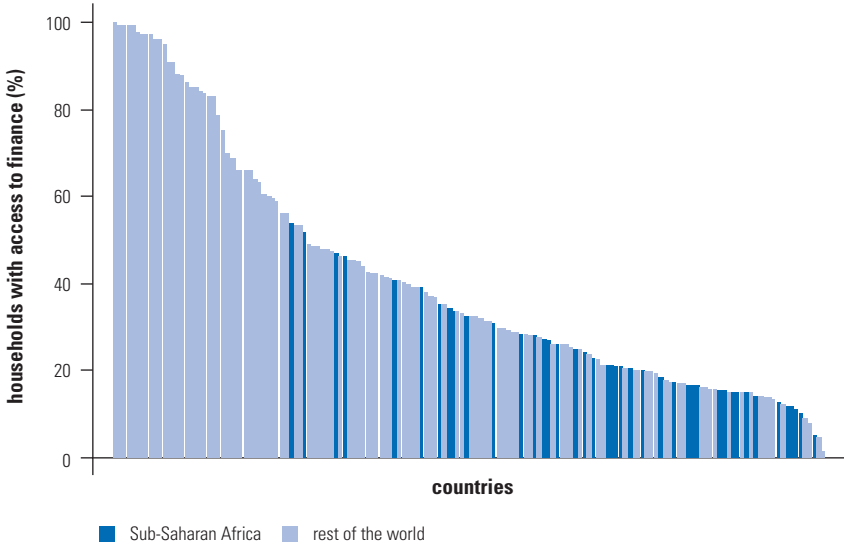
Source: Honohan 2006.

Note: The figure shows the percentage of the adult population with access to an account. It shows mean, median, maximum and minimum values for countries in each region. The median is higher than the mean in Latin America and the Caribbean and in the Middle East and North Africa; the mean is higher than the median elsewhere.

It is worth stressing that these estimates do not purport to include traditional informal finance. In addition, of course, most Africans—perhaps as many as 80 percent—are involved in informal finance groups. Important though these informal financial services are, they are not the focus of this book. A more in-depth picture of household financial access can be obtained by survey methods, and a new wave of surveys focusing on finance is under way. So far, these kinds of data are available for only a handful of African countries, all south of the Limpopo River.

Numerous factors contribute to low access percentages. The low population densities and communications and transportation deficiencies that characterize most, although not all, African economies likely increase the cost of market exchange between different agents in the economy, as people, goods, and services must travel longer distances. Further, most Sub-Saharan African countries have lower branch and ATM penetration, both demographically and geographically, than developing countries in other regions. In addition, the difficulties of establishing and maintaining com-

FIGURE 2.18
Access to Finance across Countries



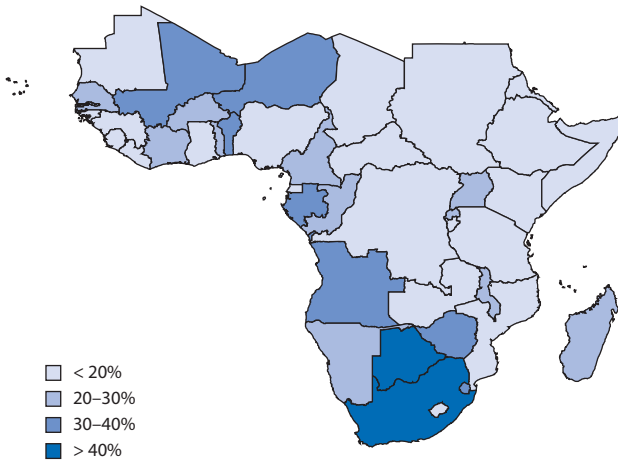
Source: Honohan 2006.

Note: The figure shows the estimated percentage of households in 158 countries with access to formal financial services. African countries are shown in color.

munication and transportation networks exacerbate the negative effect of scarcely populated economies by further increasing the cost of market exchange. Africa has the lowest road density in the world, with the notable exception of South Asia (which, in contrast, has a much higher population density). Recent technological advances and innovations, such as mobile branches or mobile banking (by mobile phones²²) have helped reduce this barrier, as we discuss in more detail in chapter 4.

Affordability is another important barrier. Low levels of income and the lack of steady income flows make large parts of the population “unbankable” in the eyes of traditional financial service providers such as banks. Seen from the demand side, high minimum balances and monthly fees can prevent large parts of the population from accessing formal financial services.²³ In Ethiopia, Sierra Leone, and Uganda, a sum equivalent to more than 50 percent of per capita GDP is needed to open a checking account. In Malawi, Sierra Leone, Uganda, and Zimbabwe, annual fees associated with a checking account amount to more than 20 percent of per capita GDP.²⁴

MAP 2.4

Access to Finance by Households

Sources: Honohan 2006, with additional data obtained for Guinea Bissau from Banque Centrale des Etats de l’Afrique de l’Ouest and World Bank staff estimates for Chad, Equatorial Guinea, and Somalia.

Compare this system with many developing and advanced financial systems that have no minimum balance requirements and no fees associated with routine checking account use (Beck, Demirgüç-Kunt, and 2006).²⁵

Eligibility is another hurdle for accessing financial services. In Swaziland, legislation mandates that a woman can be party to a contract (such as opening an account or taking out a loan) only with the consent of her father, her husband, or another male family member. This requirement might explain the large gender gap in bank accounts—52 percent of men have accounts, but only 30 percent of women. Documentation requirements for opening a bank account can be another important hurdle. Such requirements seem to be more onerous in African countries than elsewhere. In many African countries, new customers need a form of identification, payment slip, letter of reference, and proof of residence before being able to open an account. Compare these requirements with those of many non-African countries, where only one or two of these documents are required (Beck, Demirgüç-Kunt, and 2006). The documents can be hard to obtain. In Nigeria, passports are issued only for approved travel purposes. Driver licenses are available only to drivers, and proof of a registered residential address excludes the population living in rural areas and in informal settlements (Truen and others 2005). The requirement for proof of formal income

excludes all but government officials and employees of medium and large enterprises. Anti-money-laundering legislation can have a profound impact on access, by tightening documentation requirements and preventing innovative financial institutions from working around these traditional identification requirements. Chamberlain and Walker (2005) estimate that 35 percent of adults in Namibia and 30 percent in South Africa are not able to provide proof of their physical address, as required by anti-money-laundering legislation. The situation is even worse in low-income Swaziland, where 75 percent of adults do not have a verifiable address.

Finally, there is the barrier of inappropriate product features. Bank accounts with all the bells and whistles might be not only too costly but also inappropriate for large numbers of Africans, who need only simple transaction or savings accounts. Checking accounts and built-in overdraft facilities can lead to overindebtedness, especially for individuals who have irregular income and spending needs. Recently, banks across the continent have come up with simpler transaction accounts, partly owing to political pressures. The Mzansi account in South Africa, introduced with the financial charter, resulted in 1.3 million new accounts over nine months, a 10 percent increase in the “banked” population. Banks in Kenya, Uganda, and other countries have introduced new account types, as we discuss in more detail in chapter 4.

Many financial services are not only costly and unsuitable for low-income customers, but also of low quality. According to firm-level surveys, it takes five days to clear a check in South Africa and Uganda, and seven days in Mozambique—longer than the time for an international wire transfer. In most Latin American countries, by contrast, it takes two days.

Affordability, eligibility, and product appropriateness barriers are lower for nonbank financial intermediaries that cater to lower-income households. These intermediaries range from post office savings banks to credit unions and other financial cooperatives to other formal and semiformal microfinance providers. Accordingly, it is to these intermediaries that most African households have resort.

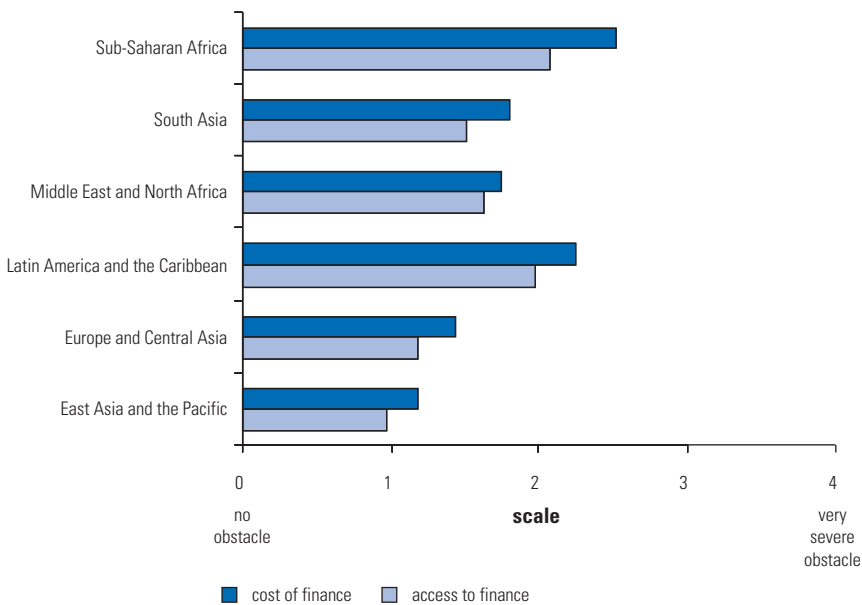
Enterprises Place High Value on Better Financial Services

If a single survey statistic justifies a development focus on finance, it is this finding: more African enterprises report that access to and the cost of

finance are major constraints on the operation and growth of their firms than do entrepreneurs in other regions (figure 2.19).²⁶ This finding comes from firm-level surveys that have enabled us to assess firms' financing constraints and patterns since the early 1990s. Here we rely on the most recent efforts, the World Bank's Investment Climate Assessment (ICA) surveys, which also enable international benchmarking of African firms.

The financing patterns of firms in Africa show some similarities to, but also some striking differences from, those of firms in other regions, as can be observed in figure 2.20. African firms finance about 68 percent of their investment needs with internal funds, more than firms in Latin America and Asia, but less than firms in the Middle East and North Africa and in Europe and Central Asia. Firms in Africa finance a smaller share of investment with bank credit than do firms in East Asia and Latin America, but a larger share than do firms in the Middle East, Europe and Central Asia,

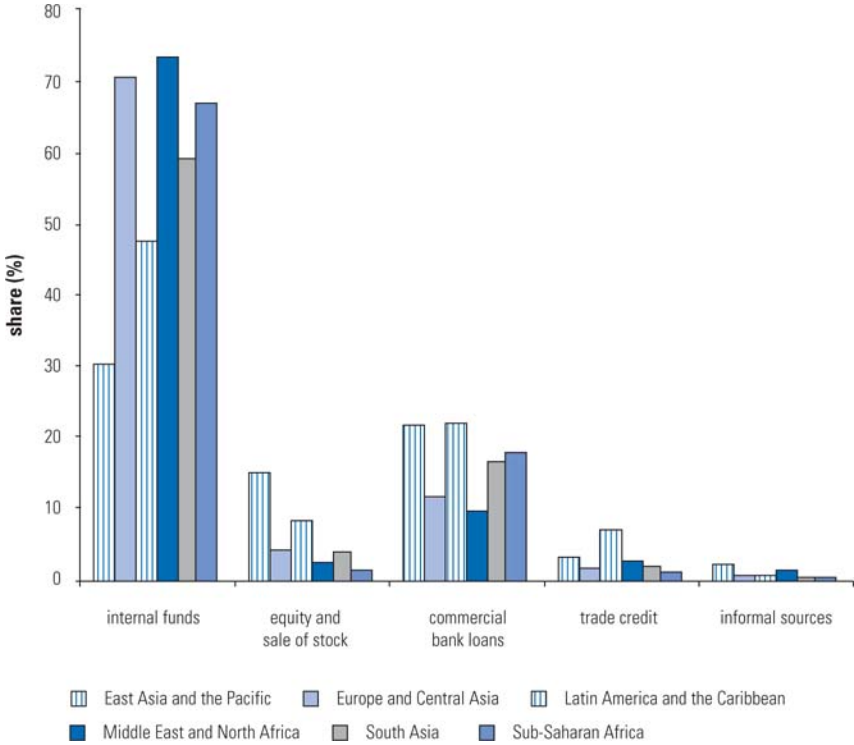
FIGURE 2.19
Financing Obstacles across Regions



Source: World Bank Investment Climate Assessment surveys.

Note: The figure shows mean ratings for surveyed firms of access to and cost of finance as obstacles to business operation and growth. Ratings were on a five-point scale: 0 = no obstacle, 1 = minor obstacle, 2 = moderate obstacle, 3 = major obstacle, and 4 = very severe obstacle.

FIGURE 2.20
Sources of Financing for Investment across Regions



Source: World Bank Investment Climate Assessment Surveys.

Note: The figure shows mean shares of different sources of funds for financing new investments by manufacturing firms.

and South Asia. However, firms in Africa finance less investment with equity finance than do firms in any other region—most likely reflecting the underdevelopment of capital markets—and they finance less investment with trade finance than firms in any other region, which might reflect low levels of trust.

The low reliance on trade credit might seem surprising because supplier credit has often been seen as a substitute for bank credit (Fisman and Love 2003). Small firms, in particular, can benefit from trade credit from large firms if the large firms have access to bank finance. Furthermore, the reliance of trade credit relationships on soft information and their link with real transactions should make trade credit especially appealing in an environment so hostile to formal banking credit. Trade credit should be

more appropriate, because it is a more flexible arrangement than formal banking relationships in the face of unexpected shocks. The degree to which domestic trade credit at the small scale is confined to networks largely working within particular ethnic communities, partly as a response to the difficult business environment (Eifert, Gelb, and Ramachandran 2006), is touched on below.

As elsewhere, small firms in Africa use fewer formal external financing sources than do large firms (Beck, Demirgüç-Kunt, and Levine 2004). Interestingly, the lack of demand for formal external finance does not vary significantly across firm size (see table 2.6). But firm size eases financing constraints, which leads to the probability that firms' unmet credit demand increases as one moves from large to medium-size to small to micro firms.

Previous research using ICAs has pointed to a large share of firms that do not apply for credit. Researchers have inferred a lack of credit demand by firms—especially small firms. Digging deeper into reasons firms have not applied, however, yields a very different picture. Table 2.6 lists the percentages for three categories of firms; first, firms that applied for and received a loan; second, a group of firms with no demand for loans; and third, a group of firms that is credit constrained—that is, that either applied for a loan and were rejected or did not apply because they did not have sufficient collateral, the application process was too difficult, interest rates were too high, or they simply expected to be rejected. Including this last group of entrepreneurs who are involuntarily excluded from the credit market in the category of entrepreneurs who applied for a loan and were rejected not only reduces the share of enterprises with no demand for credit, but also makes credit-constrained firms the largest group among the small firms.

TABLE 2.6
Credit Demand and Constraints across African Enterprises

	Small enterprises	Medium enterprises	Large enterprises
Received loan (%)	24.8	32.0	55.6
No credit demand (%)	34.0	39.8	32.5
Credit constrained ^a (%)	41.2	28.2	11.9

Source: World Bank's Investment Climate Assessment surveys.

Note: Calculations are based on surveys from Kenya, Madagascar, Senegal, and Uganda. Small enterprises have fewer than 25 employees, medium have 26 to 100, and large have more than 100.

a. Includes firms that applied for a loan and were rejected and firms that did not apply because they (a) did not have sufficient collateral, (b) found the application process too difficult, (c) found interest rates too high, or (d) expected to be rejected.

Beyond the observation that smaller firms have less access to financial services, many observers of firm finance in Africa have commented on the phenomenon of the missing middle: medium and large firms can access formal financial institutions, while microfirms often have access to MFIs (Kaufmann 2005; Sacerdoti 2005). But microfirms that are growing have difficulty expanding because MFIs are not able to expand lending (because of lack of funds or regulatory limits on maximum loan amounts), and banks and finance companies do not consider microfirms formal enough to extend credit to them. Collateral and documentation requirements often lie at the core of the reluctance of banks to extend loans to this segment of firms.

One of the problems faced by many enterprises in countries in Sub-Saharan Africa, as in many other developing countries, is high collateral requirements—often over 100 percent. On average, 83 percent of firms in Sub-Saharan Africa must supply lenders with collateral or a deposit, a proportion similar to that in other regions of the world. Lack of sufficient collateral is widely cited as a reason for not applying for or for being refused credit. In the median African country, firms that must offer collateral must supply 135 percent of the loan value. This figure is lower than in the Middle East and North Africa and in Europe and Central Asia, but it is substantially higher than in East and South Asia.

Numerous financial products available in advanced economies are largely absent in the African environment. Where this lack cannot be explained by the broader environmental issues, including the security of property rights, it may be due to a lack of scale. In some cases, technical fixes, such as specific legislation or an improved information environment, could help. This last consideration is especially pertinent for those products that could potentially compensate for other harder-to-correct weaknesses in the environment, especially for those small firms in the missing middle.

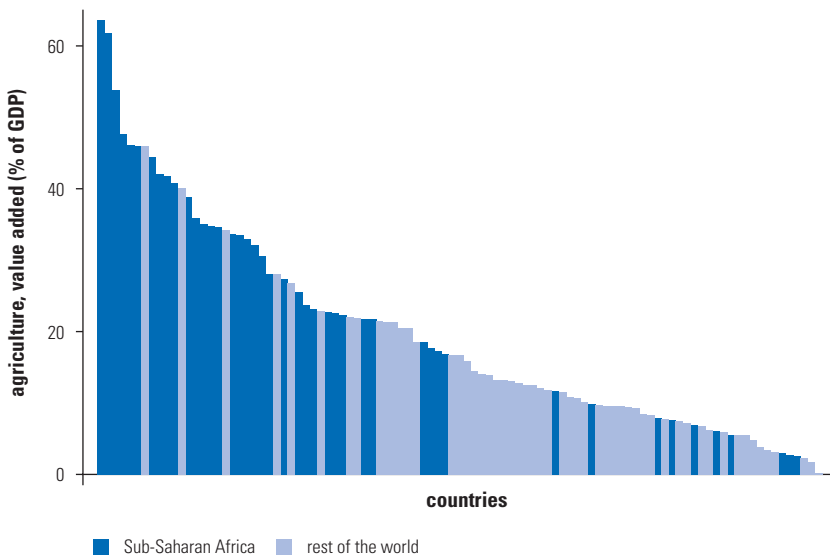
Leasing is an efficient financing tool for small and medium enterprises because it relies on the underlying asset and the cash flows it generates as collateral rather than on the enterprise's and the owner's wealth. Leasing has developed in some African countries, often jump-started with assistance from the International Finance Corporation, but it is often still hampered by tax complications or regulatory uncertainty because of the lack of specific legislation. Although leasing has the advantage that the lessor (lender) owns the leased equipment, this benefit does not always translate

into speedy recovery in the case of delinquency, owing to the complexities of court procedures, which are often compounded by judicial inefficiency, if not corruption.

Factoring—which is not a lending technique, strictly speaking—involves the purchase of accounts receivables by the lender or factor. In small enterprises with accounts receivable from large reputable enterprises, this financing technique is attractive because it does not rely on information about the borrower, but the obligor.

In interpreting survey findings, it is important to recognize that the firms surveyed in the ICAs are mostly formal firms in the manufacturing sector. In particular, firms engaged in agriculture—so crucial to current economic well-being across most of Africa (figure 2.21)—are underrepresented. It is clear that access to credit and other financial services is even more restricted in agriculture than in other sectors, and more restricted in rural settings than in urban ones. Much agricultural activity,

FIGURE 2.21
Share of Agriculture across Countries



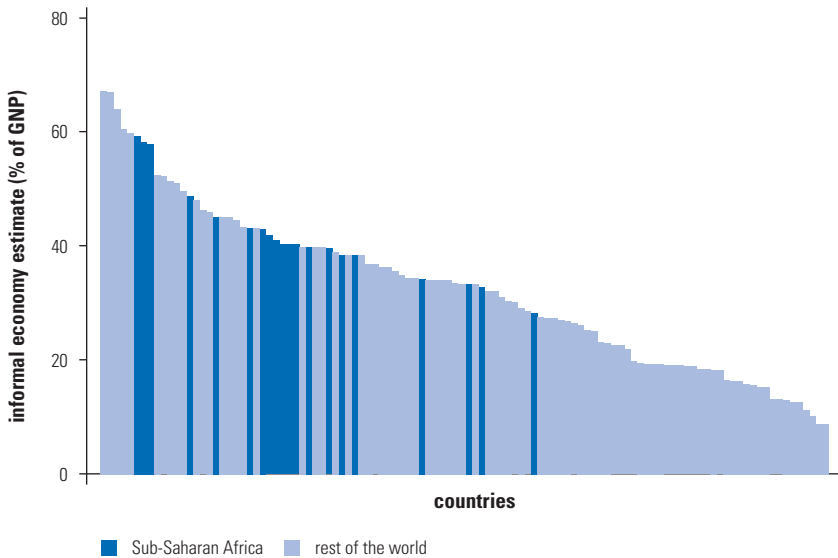
Source: World Bank's World Development Indicators database.

Note: The figure shows the contribution of agriculture (value added) to GDP in 99 countries. African countries are shown in color. All data are for 2005.

especially subsistence agriculture with staple crops, does not lend itself easily to traditional loan products. It requires innovative solutions, as discussed in chapter 4. But even cash crop farmers have a hard time securing external financing because of frequent crop failure and price volatility.

As in household finance, informality is often a major hurdle in accessing formal financial sources, especially in the absence of formal documentation of ownership claims over immovable assets that could be used as collateral. Contract claims cannot be enforced against firms that are not formally registered. Informal economic activity is also disproportionately important in Africa (figure 2.22).²⁷ There can be no doubt that this sector too is starved of formal finance, having access to it only indirectly (for example, through assistance from friends and relatives—including public servants who access bank credit through salary loans).

FIGURE 2.22
Share of Informal Economic Activities across Countries



Source: World Bank's Doing Business database.

Note: The figure shows estimates of the informal economy for 110 countries. African countries are shown in color. All data are for 2005.

Notes

1. Throughout this book, *Africa* refers to Sub-Saharan Africa.
2. An intriguing recent discovery is that high poverty seems to be associated with low subsequent national investment rates, but only in countries with low levels of financial depth (Lopez and Serven 2005).
3. However, one should not overlook the limitations of both indicators. Both are measures of size; they do not indicate the efficiency with which financial services are delivered or the quality of those services. Also, both are measures of financial aggregates and, as such, do not give any indication of the penetration of financial services to different agents in the economy—an issue to which we will come back later.
4. Even if an Africa dummy is not statistically significant, examination of the pattern of outliers is meaningful.
5. The low financial depth, despite moderate inflation, in the two CFA franc monetary unions—Communauté Financière d’Afrique (West Africa) and Coopération Financière en Afrique Centrale (Central Africa)—has been long observed. The relative openness of the capital account and a fear of devaluation were once posited as explanations, though neither explanation has as much force now as it would have had in the years before the devaluation of 1994. This study uses the term *CFA zone* to refer to both unions.
6. The level of offshore deposits might also be related to factors unrelated to capital flight, such as use by multinational enterprises or exporters. However, the level of capital flight might be understated by the level of offshore deposits because it does not include capital flight through nonbank channels.
7. In the following, we will use margins (the net interest revenue relative to total earning assets) rather than spreads (the difference between lending and deposit rates) owing to better data availability. Margins are generally lower than spreads because they exclude interest that has not been paid on nonperforming loans.
8. The other main components are loan-loss provisions and noninterest income (such as fees). Thus (approximately), before tax profits = net interest margin + noninterest income – overhead costs – loan-loss provisions.
9. The data used here are for the period 2000 to 2004 and include data on 2,157 banks from 110 countries, including 174 banks from 20 African countries.
10. In 1994, the price level in the Democratic Republic of Congo (then Zaire) increased by a factor of 240.
11. The custom in many English Common Law countries of a general lien against all assets of a borrower also helps bind the borrower to a specific lender, especially given the high registration costs of such liens.
12. It is remarkable that the big-three banks in Nigeria managed to retain as high a share as they did, given the proliferation of state (provincial) government-owned banks from the 1960s on and of private commercial and merchant banks in the late 1980s (Brownbridge and Harvey 1998). The 2005 consolida-

- tion will likely lower the effective market power of the big three even if it does not affect their combined market share by much.
13. For instance, half the stocks listed on the Namibian stock exchange are also listed on the Johannesburg exchange (a fact whose origins lie in the precise formulation of Namibian exchange controls, which have allowed fund investment in what are primarily South African companies, provided they are locally listed; see Moss 2003). Five other exchanges—those in Botswana, Ghana, Malawi, and Nigeria, and Zambia’s Lusaka exchange—also have primary or secondary listings of one or two firms that are listed in Johannesburg. The largest company listed on the Ghana exchange, AngloGold Ashanti, has its primary listing in Johannesburg and is listed on six other exchanges; most of the trading in AngloGold Ashanti occurs on the New York Stock Exchange. There are also cross-listings between the East African exchanges.
 14. Some exchanges have listed firms that have not issued any new securities; market valuation of firms can also increase without the firms raising any new funds.
 15. These concepts are spelled out in World Bank (2006).
 16. Such rules refer both to the maximum percentage of a company’s equity allowed to be controlled by any one foreign investor (5 or 10 percent in exchanges such as those of Botswana, Ghana, Malawi, Tanzania, and Zimbabwe) and to ceilings on the total percentage of foreign ownership of the share (or at least on foreign ownership of the free float). These ceilings are 49 percent in Malawi and Zimbabwe, 55 percent in Botswana, 60 percent in Tanzania (which did not allow foreign portfolio investment in listed equities before 2004), 74 percent in Ghana, and 75 percent in Kenya, for example. There are no particular restrictions of foreign ownership of shares in Mauritius, Uganda, or Zambia.
 17. The reluctance of domestic investors to commit themselves to sizable stakes is exemplified by the flotation of Ghana’s Produce Buying Company in 2000, which failed to raise the expected funds from the general private sector, leaving the social security fund holding a much higher share (49 percent) than the 20 percent originally envisaged. Moss (2003) documents the risk factors that were probably in the minds of investors.
 18. The issue was greatly oversubscribed, and the shares went to a premium of 326 percent on the issue price in the first day’s trading. The number of applicants exceeded 250,000—two and a half times the previous number of registered shareholders in the market.
 19. With the exception of those in Mauritius, Namibia, and South Africa.
 20. For comparison, housing finance comes to between 15 and 21 percent in Chile, Malaysia, and Thailand and reaches 65 percent in Ireland and 78 percent in the Netherlands.
 21. Note that the curve-fitting methodology used to arrive at these estimates was chosen so as to, if anything, err on the high side for countries at the low end, thereby perhaps exaggerating access percentages for some low-income African

- countries (Honohan 2006). The overall figure of 20 percent should therefore be taken as an upper estimate.
22. Countries in Africa have some of the lowest telephone penetration rates in the world, whether fixed line or mobile, but mobile penetration is increasing rapidly.
 23. There seem to be different pricing models for account services. Some banks seem to rely more on large unremunerated minimum balances, while others rely on large monthly fees. A third model, such as in South Africa, tries to impose individual charges on each account-related service.
 24. A sad story is told of a widow in Ghana whose €907,000 savings deposit (more than US\$100), accumulated from savings earned carrying goods in Accra's Makola market, was completely eroded over a period of two years (2003–05) by annual charges imposed by her bank after they increased the minimum balance requirement on savings deposits (Adabre 2005).
 25. The cross-country data are based on survey responses from the largest banks in each country. They are averages for all banks that responded, weighted by their share in the deposit market. For more detail see Beck, Demirgüç-Kunt, and Martínez Pería (2006).
 26. Although these are subjective assessments, note that Beck, Demirgüç-Kunt, and Levine (2006) find that in countries where firms report greater financing obstacles, industries that depend more on external finance grow relatively more slowly and investment resources are reallocated more slowly as demand changes across industries. Also, Beck, Demirgüç-Kunt, and Maksimovic (2005) find a significant negative impact of financing obstacles on firm growth.
 27. On average, more of the economy is informal in Sub-Saharan Africa than in other continents. Schneider (2005) estimates the average share of GDP contributed by the informal sector in 32 Sub-Saharan African countries other than South Africa at 44 percent, compared with 43 percent in Latin America, 40 percent in Central and Eastern Europe and the countries of the former Soviet Union, and 30 percent in Asia. The International Labour Organization (ILO 2002) data (for fewer countries) show the share of informal employment in nonagricultural employment as 78 percent for Sub-Saharan African countries other than South Africa; 65 percent for Asia, 51 percent for Latin America, and 48 percent for North Africa.

Finance for Long-Term Growth: Enriching the Flow of Finance to Transform the Economy

Introduction: Mainstream Financial Institutions

Finance's contribution to growth and stability

This chapter deals with the functioning of mainstream financial institutions as mobilizers of funds, providers of risk management services, and financiers of medium- and large-scale enterprises and government. It is in these ways that finance makes its major contribution to sustained economic growth and stability.

With the prospect of an increased flow of external funds of various forms, the major challenge facing African financial systems is that of absorption. How can policy help ensure that these funds are effectively channeled into productive growth, generating uses in both rural and urban areas?

We begin with banking, noting the endemic high liquidity in much of Africa's banks and considering how this liquidity could be more effectively employed over time. Here, of the quartet of distinctive African environmental factors—scale, informality, governance, and shocks—the last two are especially evident.

A need to improve contract enforcement and transparency of information

An ever-growing body of evidence supports the relevance of a proposition that has been reiterated by modernist observers for decades—namely that

improving information and contract enforcement is important for helping manage idiosyncratic shocks. We show that this proposition is especially important in Africa and also highlight the importance of avoiding overly activist prudential regulations that constrain banking effectiveness without materially improving systemic stability.

Ownership of African banks has been evolving rapidly. The likely effect of the return of the international banks (including, but not limited to, those based in South Africa) is reviewed, as is the growth of regional banks; both are positive developments. Recurrent political interest in state-sponsored development finance institutions (DFIs), by contrast, is unlikely to produce results any more successful than the last wave of such institutions, essentially because of governance problems.

Governments are not the best source of long-term funds—

In particular, government-owned and -operated DFIs are not the most promising sources of long-term resources. Long-term funds can be sourced from pension and social security funds, given the right governance structures, and complemented by a more energetic approach to investment banking by the leading intermediaries. Good allocation of long-term funds will benefit from effective securities markets to help make pricing transparent. The regulatory model of existing African securities markets may not be the most appropriate one, however, at least for the smaller countries, as we will explain: in regulation, the modernist model may have been taken too far. The housing and infrastructure sectors demand longer-term funds with specific and typically more limited risks. We review the prospects for financing each, using new approaches.

—But they do need to provide a stable macroeconomic environment

The last section of the chapter turns to macroeconomic issues, pointing out the need to ensure that government policy does not destabilize wholesale financial markets either through debt management policy or through the response of the monetary authorities to shocks such as those resulting from aid inflows. The potential for further regional integration is briefly explored, highlighting the desirability of focusing efforts on those steps that can help improve governance and those that can help overcome the costs of operating at too small a scale.

Improving the Banking System's Ability to Intermediate Funds

Ensuring Bank Lending Capacity

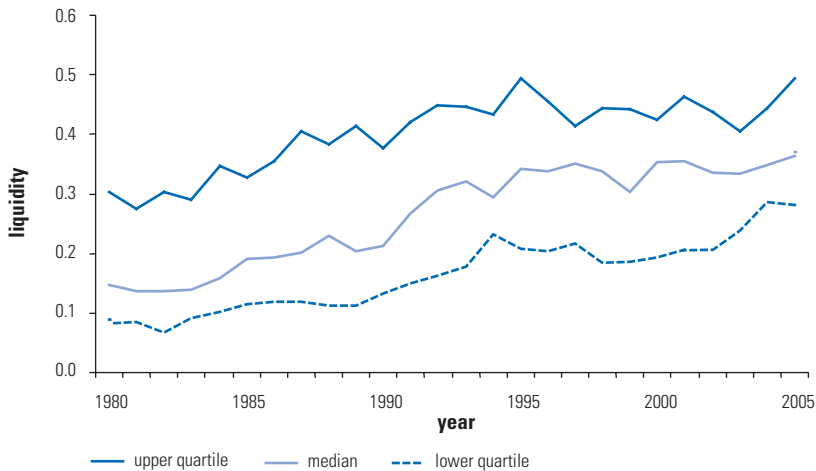
For the foreseeable future, the bulk of investable funds mobilized by African countries' financial systems will be intermediated by national banking systems. Ensuring that the banking system does a good job of intermediating is crucial to the effectiveness of banking systems; neglecting this sector will mean stagnation.

What can Africans hope to get from their banking systems? Certainly they can get more than just credit. Bundled into the operating methodology of all commercial banks is a range of liquidity, risk reduction, payment, and credit services. Credit is a key ingredient in and a major contributor to the functioning of the economic system. Yet African bankers and their customers complain about inadequate volumes of credit. Both would like to see greater volumes of credit, provided it was going to be profitable. From the points of view of borrowing firms and of farms, better availability of affordable credit would remove a significant constraint to expansion.

So why do African banks not lend enough? By their own accounts, in a remarkable number of African countries it is not a lack of mobilized funds that constrains the bankers. As noted in chapter 2, many African banking systems are rather liquid by international standards. As shown in figure 3.1, this is nothing new. Indeed, the median ratio of liquid assets to lending in the aggregate banking balance sheet of African countries has crept up over the years.

Plotting bank liquidity—here defined broadly to include foreign assets as well as local-currency reserves—against monetary depth—the ratio of broad money to gross domestic product (GDP)—helps identify the countries that are most affected by this endemic excess liquidity. It also puts this information in a perspective that shows that excess liquidity can coexist with very limited investable funds (figure 3.2). The International Monetary Fund (IMF 2006) provides a complementary analysis in terms of required and excess domestic reserves. The systems that have mobilized the most resources are not the ones that experience the most excess liquidity. Indeed, if anything, the downward sloping pattern of the plot suggests that excess liquidity tends to coincide more often with limited monetization: the population is unwilling to save in monetary form, and the banks are unable to lend even the limited resources that they have.¹

FIGURE 3.1
Liquidity of the Banking System in African Economies

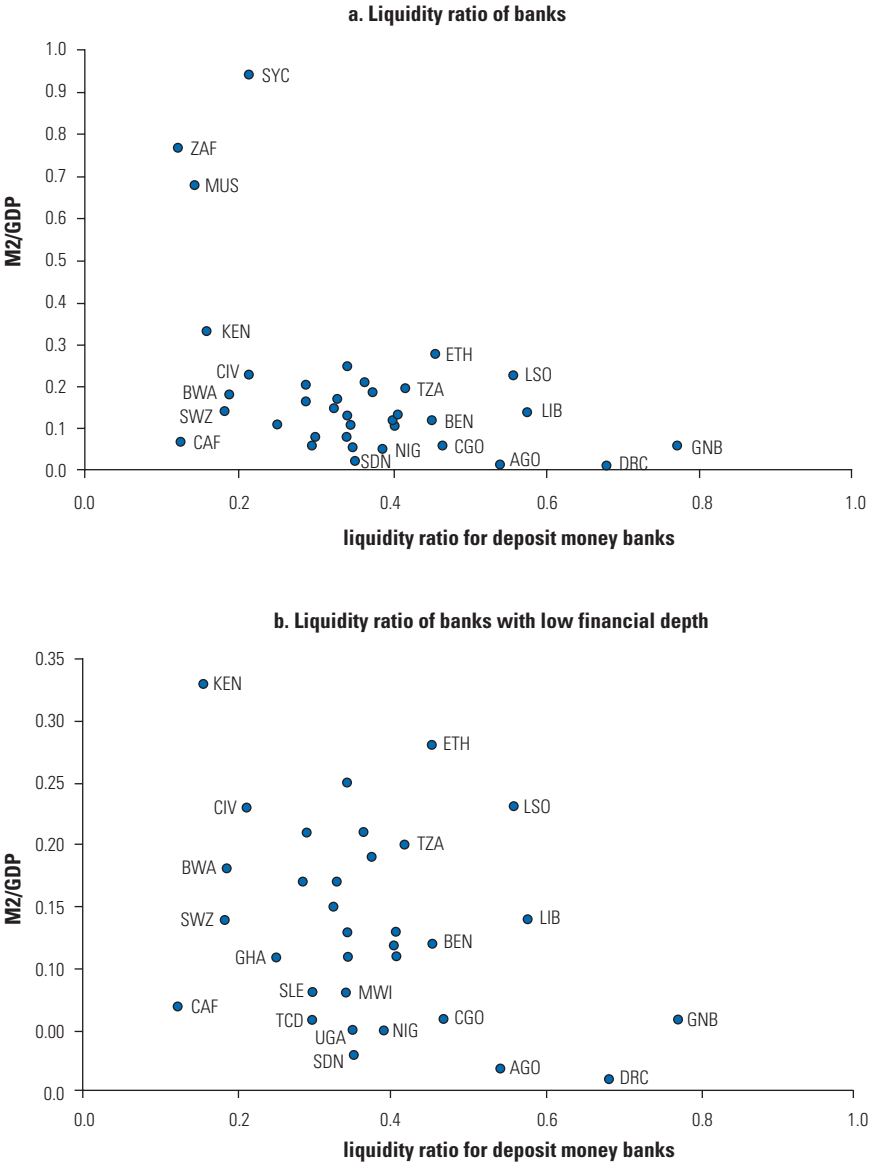


Source: Authors' calculations.

Note: Liquidity is defined as the reserves plus foreign assets of banking institutions divided by the total credit, as in the International Monetary Fund's International Financial Statistics database, lines 20 + 21/(22a..g).

Some of this trend reflects the capital restructuring of failed banks that saw their loan book written down or removed.² But it clearly indicates either a problem with generating sufficient satisfactory loan business or a response to perceived liquidity risk. Bankers generally point to the former, though some banks—often foreign-owned ones—are in a position of currency mismatch, having taken more deposits denominated in foreign currency than can prudently be lent out in the local economy (box 3.1). First, and most stridently, bankers complain of a lack of acceptable or “bankable” loan applications. Second, some banks (often the smaller ones) feel constrained by regulatory requirements for diversification of risks: when a single loan must not exceed a quarter of the bank’s capital, they find that they do not have enough capital to finance certain large projects. These issues are not new; they have persisted through the past couple of decades. Bankers’ avowed inability to lend the resources they have mobilized slows their efforts at mobilization (branches, services) and discourages expansion. We consider both issues in turn, concluding that lack of bankability is likely the more acute and intractable problem. Still, some easily implemented measures on the regulatory side could help.

FIGURE 3.2
African Banks: Financial Depth and Liquidity, 2004



Source: Authors' calculations.

Note: Country abbreviations are included in the acronym and abbreviations list at the front of the book. *Liquidity* is defined as the reserves plus foreign assets of banking institutions divided by the total credit, as in the International Monetary Fund's International Financial Statistics database, lines 20 + 21/(22a..g). Panel b zooms in on countries with low financial depth.

BOX 3.1

Dollarization

The share of bank deposits denominated in foreign currency in African banking systems has risen sharply in recent years. This phenomenon has been relatively unremarked, so policy makers experiencing it in their own country tend to see it as unique to them. In fact, dollarization ratios for the two dozen African countries for which data are available display distribution and growth to similar ratios in other parts of the world (see table).

Dollarization of Bank Deposits

(foreign currency as a percentage of total deposits)

	Africa (2004 or latest year)	World (2004)	Africa (change since 1994)
Mean	33.7	32.6	12.7
Median	29.3	29.5	16.4
Upper quartile	44.1	47.9	16.2
Lower quartile	12.8	10.4	7.1

Sources: De Nicoló, Honohan, and Ize 2005; Levy-Yeyati 2006.

Information and Contract Enforcement

In contrast to the experience of bankers in advanced economies, where lending is usually more profitable than holding government securities or liquid assets abroad, bankers in Africa have often found lending to be a relatively unprofitable line of business. This trend has been shown, for example, in two detailed recent studies of Nigerian and Ugandan banks (Beck, Cull, and Jerome 2005; Clarke, Cull, and Fuchs 2006). It is easy to see why, generally speaking and in normal times, lending can contribute much more to value added and to the profitability of banks. After all, it is through lending that banks exploit their comparative advantage in credit appraisal and monitoring. Why has it been otherwise in Africa? At times, in some countries, heavy government reliance on domestic borrowing has sent the yield on national government securities so high as to choke off demand from nongovernmental borrowers. But crowding out is far from the whole story and has not occurred in all countries.

About a third of bank deposits in African countries for which data are available are denominated in foreign currencies. The highest figures recorded are for Liberia (90 percent), the Democratic Republic of Congo (86 percent), Angola (72 percent), and Mozambique (60 percent). For the countries for which data are also available for 1994, there has been an increase of about 1.0 to 1.5 percent per year on average, close also to the worldwide average rate of increase in dollarization. Cross-country research suggests that past inflation and confidence factors are influential in increasing the rate of dollarization. By stabilizing the macroeconomy some countries have managed to reverse dollarization, but overall there has been an upward worldwide trend (De Nicoló, Honohan, and Ize 2005).

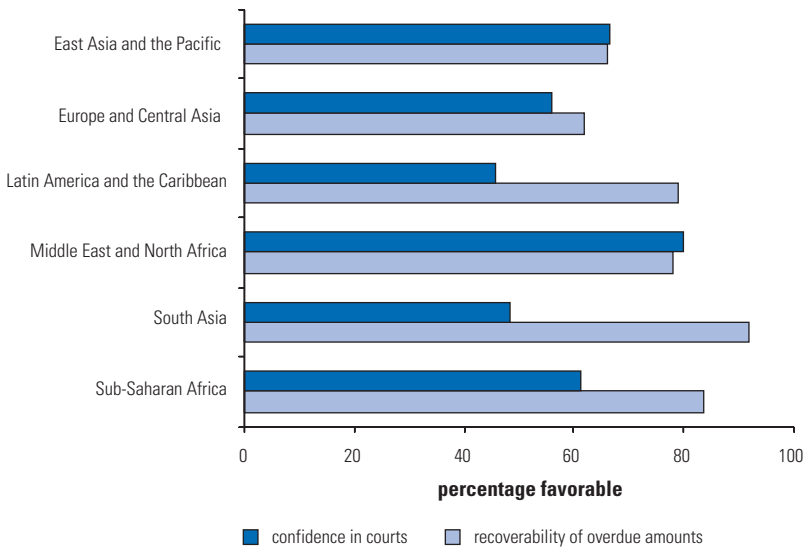
Dollarization presents prudential risks and limits the ability of the banks to onlend their mobilized resources in local currency. On average, one of every two dollars mobilized in foreign-currency deposits tends to be invested abroad. But given the perceived exchange rate risks that induce depositors to hold foreign-currency accounts, the alternative is offshore deposits. Outlawing foreign-currency deposits is unlikely to be a preferred option. But any taxes and regulations that favor foreign-currency deposits should be reviewed. For example, Liberia had, until recently, much lower reserve requirements on foreign-currency deposits. And maintenance of a stable macro and monetary environment can help limit the growth of dollarization.

Instead, bankers are unanimous on the two main factors that discourage lending. First is the difficulty of obtaining the information about potential clients that they need to assess those clients' creditworthiness. Second is the difficulty of enforcing creditor rights. Without these two essential ingredients, the banks are left with costly, time-consuming, and unreliable procedures for precredit appraisal and without the comfort of speedy recourse to foreclosure if things go wrong.

Africa is not alone in being deficient in these respects. Indeed, of the six major regions with which the World Bank deals, Sub-Saharan Africa scores third in business confidence in the judicial system and in the World Bank's index of property rights (figure 3.3).³ And reforms are taking place.

A special commercial court established in Tanzania was greeted with enthusiasm by the business community, though—perhaps inevitably—early achievements were not fully maintained. In Rwanda, the time taken to resolve a dispute fell by 22 percent following the introduction of a specialized court for business, financial, and tax matters (World Bank's Doing

FIGURE 3.3

Business Opinion on Courts and on the Recoverability of Overdue Amounts

Note: Bars show the percentage of respondents with a favorable opinion.

Source: World Bank's Investment Climate Assessment surveys.

Business database 2006). The idea of a special commercial court is most attractive when it comes to complex commercial cases that require specialist expertise on the part of the relevant judiciary body; the logic of establishing a special court to deal with more routine contract enforcement matters is less compelling.

Procedural changes, many requiring legislation, can represent a more immediate and less costly kind of reform. Here Africa has a relatively poor record, second among the six World Bank regions in number of procedures and in time taken to resolve disputes.⁴ For instance, measures to streamline debtor appeals (for example, confining the appeal to matters of law and procedure, not the original evidence) and impose time limits on their filing have been introduced in several African countries. The World Bank's 2006 Doing Business database states, "The time and cost savings allowed more businesses to use the courts. Uganda saw a 62 percent increase in commercial cases filed.... 'We have more faith in the courts now, more trust,' says Musoke, a local businessman. 'The president is now mentioning us in his speeches,' adds a judge in Kampala." Evidently the reforms are believed to improve the enforcement (box 3.2).

BOX 3.2

Points to Look For in an Effective Legal System

A well-functioning legal system is a confluence of modern laws, procedural regulations, and strong institutions, backed with proper enforcement mechanisms.

Laws and Regulations

Whereas the commercial legal frameworks of former colonial powers have been significantly modified in the past half-century, the English Common Law and French Civil Code systems inherited by African countries at independence have rarely been updated. For example, advanced economies have modified their commercial legal frameworks to accommodate the varied types of trading and complex financing arrangements (including concepts such as leasing, securitization, and derivatives trading) that characterize modern and evolving market economies. A particular difficulty for countries with a Civil Code tradition is their inability to take advantage of many new financial instruments, because they have not been able to introduce the Common Law concept of a trust upon which such instruments are based.

To further strengthen their economies, advanced economies have also sought to shift the balance of protections traditionally enjoyed by contracting parties and have evolved different rights and responsibilities for different classes of agents. Realizing the close links between having access to credit and stimulating entrepreneurship, they have sought to ensure that the default risk was minimized through the legal system.

It is time for Africa to incorporate these kinds of changes, appropriately adapted to suit its particular circumstances. For instance, the key agriculture sector could benefit from laws facilitating the use of agricultural products as collateral, such as by introducing the concept of warehousing, and from better price discovery mechanisms for farmers, such as could result from derivative trading in agricultural products. A move toward a streamlined system of conclusive land title registration would add to lenders' confidence in land as collateral, thereby promoting credit flows. In addition, collateral registration procedures need simplification, and the database should

(Box continues on the following page.)

BOX 3.2 (*continued*)

be easily accessible so as to assist in prior-charge verification, thereby preventing disputes. Similarly, the introduction of a credit information database would prevent credit arbitrage and would reward honest borrowers.

The threat of insolvency, both corporate and personal, needs to be made real and effective. A specialized approach to insolvency is required. Personal bankruptcy in most countries in Africa is a relic of the early 20th century; corporate insolvency is a part of a companies act that, in most cases, is based on concepts that have not prevailed widely for decades. A mechanism to restructure and rehabilitate viable enterprises with the active participation of the creditor community needs to be adopted.

Regulatory Institutions and Transparency Requirements

Increasing penetration of financial services such as banking, insurance, pensions, and microfinance necessitates both an enabling environment for these services to grow and a good regulatory structure to prevent diversion of funds. Unscrupulous elements can exploit the cloak of limited liability to defraud unsuspecting individuals of their hard-earned money. Opacity in the functioning of institutions that access public money and provide public services can lead to disastrous events. Good corporate governance practices, supplemented by proper accounting and auditing principles, are a must, particularly for companies that operate in these sectors. To enable them to highlight weak internal governance in these companies, independent professionals need to be trained through capacity-building efforts. Establishing appropriate disclosure standards and strict, efficient enforce-

As far as credit information is concerned, African countries tend to be behind the rest of the world. Partly this tendency reflects a delayed catch-up to a new wave: worldwide, the proportion of countries with a credit registry jumped from 46 percent in 1988 to 70 percent in 1998 and to 80 percent in 2003; in Africa, the percentage is still just 60 percent. Furthermore, the coverage of the population and the extent of information that registries contain are lower than in other regions—much lower, except for South Africa and its small neighbors (World Bank's Doing Business database 2006). Part of the problem here is the informality of residence and the lack of stable individual identifiers. There are substitutes for a national identity card. Credit registries are

ment procedures should be a priority. The availability of information in the public domain can lead to proper vigilance and quick remedial measures in case problems occur. Strong regulatory institutions can enforce these disclosure standards and other regulations and ensure that the whole system functions well.

Traditional Court System and Enforcement Mechanisms

Quite apart from the necessity of having modern laws, existing legal institutions (as well as new ones) also need adequate staffing and other infrastructure resources. Financial and functional independence from other branches of the government should be encouraged because excessive reliance on the government (often the most significant litigant) usually endangers judicial impartiality.

Despite the growth in the number of legal disputes, legal and judicial institutions have remained static. There has been no corresponding increase in the number of courts or tribunals, or in the number of court personnel to service the courts. Of particular concern are the extreme delays and high levels of frustration encountered in enforcing judgments. An insufficient staff and a lack of incentives to promptly enforce judgments result in the primary relief becoming illusory. Compensation levels have remained low, and there has been little, if any, upgrading of technical skills to keep up with the changing nature of legal disputes. Even the clerical staff needs training on how to keep records and manage excessive caseloads. Without a significant investment in these soft skills, improvements in automation and the introduction of modern case-tracking tools will be wasted.

being built even in anglophone African countries in which they were not traditionally used, such as Kenya and Uganda, and are being expanded to cover all incidents of delinquency in countries that did not cover these issues before.

Bankers have often developed imperfect but workable bilateral arrangements for providing credit references. So they are not always in the forefront of movements to improve credit registries if doing so will entail compulsory sharing of their information with other lenders, even outside the circle of traditional banking. Therefore, although bankers need to be involved in plans for improving credit registries, authorities may need to push beyond the point where bankers want to go.

Property registries, where liens can be recorded and quickly accessed, are also part of the recommended toolkit for facilitating collateralized lending. These registries, too, are something on which many African countries are working, introducing computerized systems that can leapfrog them into quite an efficient system of collateralized lending.

The lack of reliable company accounts is also largely a function of the informality of the economies. Most countries have now adopted the International Financial Reporting Standards (IFRS), so that doctrinal issues are at a minimum. But enforcing prompt filing of reliable accounts and ensuring that the auditing profession is competent and honest are necessarily medium-term projects.

Good information and strong creditor rights are two keys to expanding credit availability. It is clear from increasingly elaborate econometric work, using the extensive cross-country databases maintained by the World Bank, that countries with stronger creditor rights and better credit information enjoy a higher volume of credit (even controlling for other explanatory factors). The borrower benefits through availability when the lender is made secure. Digging deeper, though, we notice that for poor countries, credit information seems more important in influencing the volume of lending than are the legal protections (Djankov, McLiesh, and Shleifer forthcoming). If that is so, it is good news for Africa, because fully reforming legal protections is likely to be a long and drawn-out process in poor countries, at least when it comes to protecting the creditor rights of banks against politically protected borrowers. In fact, in countries with weak creditor rights, coverage of credit registries tends to be better and vice versa: information seems to have emerged as a partial substitute for creditor rights in the countries where such rights were weaker. (This is conspicuously the case in Africa, where countries with a credit registry have an average score of only 1.1 on the World Bank's Doing Business index of creditor rights, whereas those without a credit registry score 3.7 on average.)⁵ It leaves open considerable potential for those African countries that still have no credit registries to introduce them—and for those that have them to enhance the extent, quality, and depth of the information collected.

It is not only for medium and large firms that better credit information helps improve credit availability. Indeed, the evidence shows that strengthening this area will yield even greater benefits for micro, small, and medium-scale enterprises (MSMEs) and households (Love and Mylenko 2003). Improving financial access for MSMEs is taken up in greater detail in chapter 4. Some elements

of that discussion—notably suggesting that lenders themselves can do more to develop relationship-type lending so as to overcome some of the environmental difficulties—are also relevant for the middle market.

The Role of Prudential Regulation

Could deregulation be another part of the answer to helping increase the flow of credit? To consider this, we need to review why so much attention has been paid in the past few years to upgrading prudential regulation systems.

African financial systems, like most others around the world, experienced widespread banking failures in the 1980s and 1990s. The World Bank's Banking Crisis database records 53 episodes of bank insolvency in 41 African countries since 1980, of which 40 episodes in 32 countries were logged as systemic crises. Many of these events were very costly, whether we measure the effects in terms of the fiscal outlays made to meet depositors' claims (although not all depositors were paid in all cases) or in terms of the subsequent output dip potentially attributable to the crisis. For those events for which data are available, average fiscal costs amounted to 10.6 percent of annual GDP, whereas output losses were estimated at an average of 13.1 percent of GDP (Caprio and others 2005). These figures are all broadly comparable with those recorded in other developing regions.

However, closer familiarity with the nature and evolution of African banking crises reveals that the mix of causes and symptoms was somewhat different from that in other regions. Specifically, while Africa experienced each of the three main syndromes—banking weaknesses attributable to macroeconomic boom and bust, banking weaknesses attributable to bad banking by private banking insiders, and banking weaknesses attributable to government action undermining the solvency of the banks—there were relatively few of the first type and relatively more of the last type. In particular, contrary to what is sometimes suggested, not a single systemic crisis in Africa was caused by maturity mismatches in the banks' portfolios. Even where boom-and-bust cycles (a characteristically Latin American source of crisis) were at work—for example, following the mid-1980s commodity boom in the Union Economique et Monétaire Ouest Africaine (UEMOA) countries—government influences were also at work. Parastatals and firms that had acted as unpaid suppliers to governments and their agencies were prominent in the list of defaulting borrowers.⁶ Bad banking was also at work, conspicuously in the major collapses of BCCI

(Bank of Credit and Commerce International, an international banking group headquartered in Luxembourg that successfully mobilized the deposits of wealthy individuals and state enterprises in several African countries before it failed in 1991) and Meridien-BIAO (the successor of the Banque de l'Afrique Occidentale, or BAO, a historic former bank of issue in francophone West Africa, which, when its parent was liquidated, was acquired by an aggressive but unsound banker based in Zambia before collapsing in 1995, affecting numerous countries across western and central Africa, including Swaziland and Equatorial Guinea).⁷

Smaller bank failures in Kenya,⁸ Nigeria, and other countries were also associated with insider lending and looting, often involving politically well-connected insiders.⁹ But the largest losses related to the nonperforming portfolios of dominant state-owned banks in countries such as Ghana, Tanzania, Uganda, and Zambia and of majority state-controlled banks in Benin, Cameroon, Côte d'Ivoire, Senegal, and other countries of the two African currency unions; in the Democratic Republic of Congo; in Angola and Mozambique; and elsewhere.

Bank regulation and banking supervision can be effective against incompetent or reckless management of a privately owned bank: the banking supervisors act to protect the interests of the depositors and of the wider functioning of the banking and payments system in case failures of such institutions are extensive enough to threaten that system.

By insisting on adequate capitalization, supervisors can also help protect the system against the failure of an international bank. But their abilities in such a case are limited, as witness what happened with the failure of BCCI. Despite formal agreements with the supervisors of such international banks in their home countries, the full strength of the local subsidiary may be exaggerated in its accounts to the extent that some losses or fragilities are hidden in related-party transactions with the parent bank that are opaque to the local supervisor.^{10,11}

When it comes to state-owned banks, the role of the supervisor is, in practice, often even weaker. Although the supervisor can point to balance sheet weaknesses of a state-owned bank, if the government is determined to channel the resources of the bank to favored borrowers who do not have the ability or at least the intention to repay, few banking supervision authorities have the political independence to suspend that bank's operations.

Even if limited independence meant that bank supervisors were largely unable to prevent most of the crises in Africa, this may not be the case in the

future. The greatly reduced role of state-owned banks in most African countries suggests that any future banking crises are more likely than before to have their roots in boom and bust or in bad banking.¹² Classic techniques of bank supervision may thus be more relevant than they were before. Most African bank supervisory agencies have been upgrading their capacity in recent years. However, that does not mean that every regulatory prudential measure that seems to add to the safety of banks is to be applauded. On the contrary, many such regulations are ineffective and, if they constrain the development of essentially sound risk taking by well-managed banks, could damage growth by far more than any supposed gain in safety (box 3.3).

Undue restrictions on the scope of bank operations can weaken rather than strengthen banks by limiting their profit opportunities. Recent exam-

BOX 3.3

Bank Regulation: Avoid Reliance on Extensive Discretionary Powers

Recent research on the effectiveness of prudential regulation questions the unthinking transplantation of practices from rich countries into the very different political and institutional settings that prevail in most countries. Detailed examination of cross-country evidence points to the limited effectiveness—and, in many respects, the counterproductivity—in developing countries of some standard regulatory and supervisory practices. In particular it suggests that too much reliance on discretionary powers given to government officials to keep the banking system safe, sound, and efficient may be misguided. Strikingly, it turns out that countries that grant the largest discretionary powers to their bank supervisors exhibit the most corruption in banking.

Certainly, unthinking application of the Basel II accord is not the way to go for many countries (box 3.4). Instead, in order to have banks that promote social welfare, a country needs political and other institutions that induce its officials to develop policies that maximize social welfare, not the private welfare of officials or bankers. The results also suggest certain practical rules: err on the side of liberality in entry and licensing and in relation to the permitted range of activities. The potential role of market discipline proves to be surprisingly strong, even in poor countries (see Barth, Caprio, and Levine 2005; Beck, Demirgüç-Kunt, and Levine 2006).

ples of such restrictions from the African environment include overuse of collateral requirements, unduly demanding risk concentration rules, and limits on the amount of lending to below-prime borrowers.

In some countries, banks are obliged to fully provision large, uncollateralized loans even if they are performing. For instance, recently Tanzanian regulations required 125 percent collateral for any individual loans larger than 5 percent of the bank's capital. In effect, such uncollateralized lending must be fully financed out of the bank's capital and not at all out of deposits. This practice cannot fail to place a brake on what might otherwise be sound lending backed by a credible projection of cash flow. However, as quantified in chapter 2, collateral requirements seem to be ingrained in African banking practice even where not imposed by regulation. Defenders of high collateral requirements point to the cost and difficulty of recovering even on apparently overcollateralized loans. However valid this consideration may be, it also points to the complementary importance of considerations other than collateral in loan appraisal.

Loan concentration limits can also be too constraining—though they are not always so. In the UEMOA, a single loan can reach 75 percent of the bank's capital before hitting the ceiling; this limit is probably too lenient. But if having as few as 10 loans, each just 10 percent of a bank's capital, is enough to violate aggregate loan concentration limits—as is the case in some other countries—even relatively large banks will have difficulty both in complying with the regulation and in meeting credit needs, even of customers who require no more than the equivalent of just a few million U.S. dollars. Financing large projects without hitting loan concentration ceilings tends to be a problem, particularly in smaller countries with low aggregate financial depth. After all, aggregate bank capital in Rwanda is about US\$50 million, in Chad about US\$70 million, in Mozambique about US\$350 million, and in Tanzania about US\$300 million.

Banks have ways around this problem (apart from securing exemptions from the regulatory authorities, a practice that, if widespread, both undermines the coherence of regulation and introduces the sort of regulatory discretion that can lead to corruption). For example, they can form lending consortia with other onshore banks or with offshore banks, including affiliates. However, such collaboration is costly and complicated by exchange controls and other factors. By forcing an excessive degree of information sharing, requirements for such collaboration reduce the incentive for banks to make the effort to determine the creditworthiness of large projects.

In francophone countries, the tradition of obtaining official preapproval of borrowers has been slow to die out. With its origins in the formerly widespread practice of rediscounting a sizable share of banking loans at the central bank, the system of preapproval itself was abolished many years ago. But in the UEMOA, a remnant survives in the form of the rule that at least 60 percent of each bank's portfolio must be loaned to borrowers that have been classified as eligible for refinancing. Because this regulation is not enforced, it may, in practice, be little more than a nuisance, but it is hard to square with a developmental policy. Furthermore, the idea that the banking regulator should pass judgment on the bankability of most borrowers certainly suggests a lack of official confidence in the ability of the banks to do their job.

Banking regulators need to act with restraint, therefore, in fulfilling their remit to keep banking systems safe and sound. Aggressive measures that are likely to constrain the ability of banks to take reasonable and prudent credit risks should be avoided. This is not really a question of accepting materially higher risks of failure; rather it is the avoidance of unnecessarily restrictive precautions. Adoption of the sophisticated versions of the recent Basel II accord on bank regulation is unlikely to help matters: indeed, it would be premature for most African countries (box 3.4). All in all, though, the widespread availability of exemptions and the fact that banks complain only weakly about overregulation suggests that it is not only—or even mainly—a regulatory credit crunch that limits credit growth in Africa.

Ownership and Industrial Structure of the Banking System

If the banking system is going to deliver the credit services so badly needed by African economies, how is it best organized? Are African banking systems too concentrated, too dependent on foreign ownership? Or are there too many small banks? What role should the government play? Here organizational and internationalization issues come to the fore.

Building Strong African Banking Systems

As mentioned in chapter 2, African banking systems are highly concentrated. Studies have shown that liberal entry policies can offset the market power that might otherwise be conferred by concentration (Berger and others 2004). Ensuring an adequate supply of solid banking competitors

BOX 3.4

Basel II in Africa

Banking supervisors across Africa are coming under new pressures following the introduction of the new international accord among the bank regulators of advanced economies known as Basel II. There is no official compulsion on regulators in developing countries to adopt the accord, and, indeed, the relatively sophisticated techniques envisaged in parts of the Basel II approach could be quite dangerous if applied in an environment for which the basic data and skills are not available.

For instance, the “standardized” approach to measuring bank capital requirements in Basel II envisages the use of credit rating agencies. These agencies would assign ratings to different borrowers on the basis of the capital required by banks to back loans to such borrowers. It is hard to imagine a credibly independent and authoritative rating industry emerging in small, poor economies. For one thing, there would be little or no market pressure on a rating agency to moderate its ratings, as both bank and borrower would prefer to see a higher rating. An alternative approach in Basel II is to use bankers’ own internal rating systems to assign the amount of capital needed. That approach requires the banks to be able to assign credible ratings on the basis of a statistical model of default risk.

has been a constant concern for African banking authorities, especially given the small size of the market.

Bigger financial markets can accommodate competition among large intermediaries. Squaring the circle of competition and scale thus requires financial deepening within countries, as well as more cross-border and regional banking. So far, the degree of competition provided for the main banks by local near-bank institutions is limited; however, they do have stiff competition from offshore banks for large deposits and the best corporate clients.

Changes in bank ownership

The recent pickup in economic growth across the region has contributed to some new entry and expansion in branch numbers. As mentioned in chapter 2, even credit-to-GDP ratios have been picking up. In addition, recent trends in the organization of the banking industry have been affected by

The data to build such a model do not yet exist in Africa north of the Limpopo River.

Yet international banks, already struggling to meet the new requirements for their home operations, have been urging regulators in developing countries to adopt Basel II in order to harmonize the reporting requirements banks face. Such pressure should be resisted. It is not all that hard for international bankers to prepare returns on the old basis (indeed, reporting to a region-wide regulator would achieve a greater saving, as discussed below). Also, given the complexity of the internal rating models, host regulators could not justify the expense of tooling up to assess the quality of such a model. Above all, if local banks were also allowed to use the more advanced approaches to capital requirements, the difficulty and ambiguity of assessing whether these systems were measuring risk adequately, combined with what is, in practice, a limited degree of political independence of the regulator, would quickly result de facto in a regulatory free-for-all. Although the use of statistical risk models by banks will and should become increasingly widespread in the years ahead, adoption of the advanced capital measurement methods of Basel II should be postponed for the present in Africa.

Africa will likely be affected by the implementation of Basel II in advanced economies, to the extent that it will result in higher capital requirements to back international bank lending to the region, which could constrain access by larger enterprises to offshore borrowing.

three structural changes. First are improvements in international communications (airline connections and telecommunications) in the region, which have facilitated the expansion of regional banks. Second is the bedding down of the reforms that cleaned up the portfolios of long-insolvent banks, many of them state owned, and passed their control to new shareholders. Third is the reemergence of South African banks as investors.

It is unlikely that the new wave of multinational banks in Africa would have occurred without the improvements in communications. The largest such networks so far are Ecobank and the Bank of Africa, both with their roots in the otherwise already integrated UEMOA. Recently, though, both these groups have reached beyond that zone, with the Bank of Africa opening in Kenya and Madagascar and planning an even wider network. Ecobank's proposed joint venture with the larger FirstBank of Nigeria will build scale substantially. Table 3.1 illustrates the range of cross-border banking north of the Limpopo River.

TABLE 3.1

Cross-Border Banking in Africa: Locations of Branches or Subsidiaries of 26 International Banking Groups

Banking group (country)	Angola	Burundi	Benin	Botswana	Burkina Faso	Cameroun	Cape Verde	Central African Rep.	Chad	Comoros	Congo, Rep. of	Cote d'Ivoire	Congo, Dem. Rep. of	Djibouti	Equatorial Guinea	Gabon	Gambia	Ghana	Guinea	Guinea-Bissau	Kenya	Lesotho	
Belgoaise ^a (Belgium)		✓																					
Financial Bank (Benin)			✓																				
Finabank (Botswana)																							
Afriland First (Cameroon)					✓																		
FOTSO (Cameroon)					✓																		
Cofipa (Côte d'Ivoire)					✓																		
BNP Paribas (France)					✓																		
Calyon (France)					✓																		
SGB (France)			✓		✓																		
BGFI (Gabon)					✓																		
First International (Gambia)																							
Novobanco Procredit (Germany)	✓																						
International Commercial (Ghana)																							
International Commercial (Kenya)																							
Kenya Commercial (Kenya)																							
BSC (Libya)			✓																				
Ecobank (Mali)			✓																				
Capricorn I H (Namibia)																							
Guaranty Trust (Nigeria)																							
Intercontinental (Nigeria)																							
Millennium BCP (Portugal)																							
Bank of Africa (Togo)			✓																				
Absa (South Africa)																							
Stanbic (South Africa)																							
Barclays (United Kingdom)																							
Stanchart (United Kingdom)																							
Citi (United States)																							

Banking group (country)	Liberia	Madagascar	Malawi	Mali	Mauritania	Mauritius	Mozambique	Namibia	Niger	Nigeria	Rwanda	Seo Tome and Principe	Senegal	Seychelles	Serra Leone	South Africa	Sudan	Swaziland	Tanzania	Togo	Uganda	Zambia	Zimbabwe	
Belgoïaise ^a (Belgium)				✓						✓														
Financial Bank (Benin)																								
Finbank (Botswana)																								
Afriland First (Cameroon)																								
FOTSO (Cameroon)																								
Cofipa (Côte d'Ivoire)																								
BNP Paribas (France)	✓	✓	✓																					
Calyon (France)		✓																						
SGB (France)		✓																						
BGFI (Gabon)																								
First International (Gambia)	✓																							
Novobanco (Procredit) (Germany)																								
International Commercial (Ghana)																								
Kenya Commercial (Kenya)																								
BSC (Libya)																								
Ecobank (Mali)																								
Capricorn I H (Namibia)																								
Guaranty Trust (Nigeria)																								
Intercontinental (Nigeria)																								
Millennium BCP (Portugal)																								
Absa (South Africa)																								
Stanbic (South Africa)																								
Bank of Africa (Togo)																								
Barclays (United Kingdom)	✓	✓	✓																					
Stanchart (United Kingdom)																								
Citi (United States)																								

Source: Assembled from bank Web sites.

a. Fortis, the new parent of Belgolaise, announced in 2005 that it is winding down the operations of Belgolaise.

Banks based in South Africa have long been heavily involved in the provision of banking services in neighboring countries (Botswana, Lesotho, Namibia, and Swaziland). More recently, Stanbic¹³ and, to a lesser extent, Absa have seized opportunities to acquire sizable banks further north. In 2005, UK-based Barclays acquired a controlling stake in Absa; it plans, subject to regulatory approval, to transfer all its African operations to Absa ownership and control. Thus, even if Absa is ultimately controlled by Barclays, two of the three largest banking groups outside South Africa will be run by South African concerns.

The privatization process has been long and drawn out, and it remains incomplete.¹⁴ State-owned commercial banks emerged during the early decades of independence, whether as a result of outright nationalization of existing banks by socialist governments (as in Guinea, Mozambique, Sudan,¹⁵ and Tanzania¹⁶); as a stand-alone initiative (as in Ghana, Lesotho, and Uganda); or by a process of gradual Africanization of the equity (as in most CFA countries, Kenya, and Nigeria¹⁷). The collapse of the BCCI and Meridien-BIAO left other governments holding ownership of their local subsidiaries. Increasing disenchantment with the performance of state-owned banks—not only the fiscal costs of meeting unanticipated loan losses but also disappointing functional performance—combined with encouragement from the donor community led most governments to seek to reduce their commercial bank shareholdings and to open the door to new entrants.

They adopted a range of privatization strategies. Transferring the state's shareholding to national social security funds or other parastatal entities was one approach, unlikely to influence governance by much. Another involved selling a minority stake to the general public in an IPO, as in Kenya and Nigeria; even this strategy is a weak form of restraint on management that is still largely appointed by the government. Other partial privatizations also included strategic stakeholders, sometimes with a management contract. In many cases, those stakeholders were the same foreign-owned banks as had been active in colonial times (or their successors), who entered or reentered as strategic investors. Thus, while their African networks are smaller than before, the Société Générale, Crédit Agricole, and BNP Paribas of France are again the main foreign players in the CFA zone, the last two being successors to Crédit Lyonnais and the BCI consortium that were active up to the 1980s.¹⁸ In the anglophone world, Barclays, Standard Chartered, and Standard Bank of South Africa (Stan-

bic), with Citigroup, are again among the most prominent foreign banks. Portuguese banks have reentered the Angola and Mozambique markets.

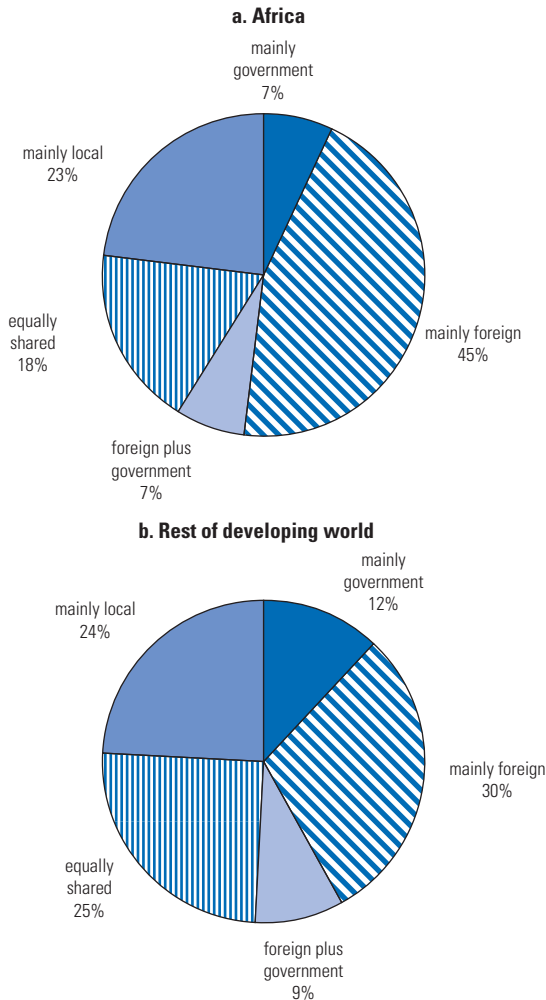
Few African governments have stood resolutely against the wave of denationalization. As discussed in chapter 2, in only three countries are most of the banking systems in the hands of the government, whereas in 20 countries foreign shareholders control more than 60 percent of the systems. (Figure 3.4 shows that Africa has gone even further than the rest of the developing world in reducing reliance on government-owned banks and relying on foreign ownership.) Even Ethiopia has permitted the emergence of private—though not foreign-owned—banks. Yet all have displayed a reluctance to cede government ownership and control altogether. In part this unwillingness has been driven by a concern that privatization of large commercial banks that provided essential financial services across the country, including in relatively remote parts, would be followed by closure of the less active and unprofitable branches. The political consequences of extensive layoffs of excess staff members have also been a concern. Broader concerns include the long-term commitment of private owners¹⁹ and their likely responsiveness to matters of national importance. Finally, it is clear that retaining a majority stake of the biggest bank in national hands, even if that stake is diffused among many holders, sometimes remains a political goal for broader ideological reasons.²⁰

Scale

The influence of ownership structure depends on the strategies and capacities of the resulting bank management. The goal of cross-border African bank management is to do profitable banking, as distinct from mainly financing existing economic groups in the home country. By sharing certain functions, such banks can also achieve economies of scale, even though for the present groups such as Bank of Africa and Ecobank remain quite small, with little more than US\$2 billion in total assets (though the FirstBank-Ecobank combination would have total assets of US\$6 billion). Of course, these attributes can be attained by national banks, especially in the larger markets such as those of Nigeria as well as those of Kenya and Tanzania, Cameroon, and (in quieter times) Angola and Côte d'Ivoire.

Achieving scale was also a goal of the Nigerian authorities' decision to impose an exceptionally high minimum capital for banks of ₦25 billion—almost US\$200 million. This decision has led to a very dramatic consolidation in the Nigerian banking market, as banks moved to merge and also to

FIGURE 3.4

Patterns of Bank Ownership: Africa and the Rest of the World

Source: Authors' estimates based on table 2.3 and the World Bank Regulation and Supervision Survey.

Note: *Mainly government controlled*, *mainly foreign*, and *mainly local* mean that more than 60 percent of total assets are held by banks majority owned by the government or majority owned by foreign or local shareholders. *Foreign plus government* means these two categories together hold more than 70 percent. *Equally shared* is a residual category.

raise new capital ahead of the end-2005 deadline. The number of banks—which had expanded substantially in the years of multiple exchange rates to take advantage of special profit opportunities that the regime offered—has shrunk from 89 to 25. An additional side benefit may have been that

the shake-up of ownership structures may have led to a realignment of existing centers of economic and financial power in Nigeria, potentially leading banks to focus more on seeking banking profitability than on serving long-established clients and thereby opening the door to hitherto underserved businesses. It is too soon to evaluate the success of the Nigerian experiment: Could it have limited entry unduly? Might the expansion of bank capital lead to a surge of unsound lending? But what is certain is that the future course of banking has been altered, not only in Nigeria but in West Africa as a whole.

Scale is what the large international banks have in plenty, and it should be a dimension from which host countries may benefit with lower costs, if competitive conditions are favorable. Each national subsidiary can draw on an enviable range of head-office services and on financial resources as needed. (Indeed, subsidiaries of the larger international banks increasingly outsource much of what can be automated to their global operations.) But their business models and goals often differ from those of domestic owners. It is clear that banks such as the African subsidiaries of BNP Paribas and Standard Chartered focus especially on serving larger, internationally trading companies and wealthy individuals. They also have important foreign clients trading with Africa. It would take a substantial change in their strategy before they chose to focus, for example, on small and medium-scale enterprises (SMEs).

Client focus

The international evidence suggests that foreign bank entry will not leave SMEs unprovided for; even if the foreign banks do not cater to this segment of firms, the intensified competition for large clients will induce local banks to move downscale (box 3.5). This result is important, because it could be a serious matter if all foreign banks focused mainly on large clients. After all, in some African countries (such as Mozambique and Madagascar) foreign shareholders control almost all commercial banking. But the indications are that the business models and practices of international banks active in Africa vary. Certainly Stanbic and Absa assert that their focus now extends to the full range of banking services and a wide clientele, and their behavior appears to bear this out. Possibly these South African banks see greater commonality between their home market and other parts of Africa. New initiatives in South Africa to reach a lower-income clientele (for example, with the new Mzansi deposit product, dis-

BOX 3.5**Foreign Banks and SME Lending: Evidence from Cross-Country Studies**

Foreign bank entry is a controversial issue everywhere. On the one hand, foreign banks are supposed to bring fresh resources, new technologies, and more efficient techniques and new skills to their host banking markets and to induce competitive pressure into the banking systems of their host markets. On the other hand, a larger presence of foreign banks might reduce access to credit, especially for SMEs, because these firms rely more on relationship lending. Furthermore, foreign banks might have less loyalty to their host countries and might withdraw in times of crises or even because of shocks in third countries and in response to global portfolio shifts. Cross-country evidence has confirmed that foreign-owned banks are more efficient than domestic banks in developing countries and that foreign bank entry does, indeed, exert competitive pressure on domestic banks to become more efficient (Claessens, Demirgüç-Kunt, and Huizinga 2001).

The empirical evidence on the effect of foreign bank entry on access to credit has been at worst mixed, if not in fact favorable. On the one hand, borrowers in countries with higher foreign bank presence report lower financing obstacles and are more likely to have access to bank credit (Clarke, Cull, and Martínez Pería 2001). Foreign bank entry helps reduce related lending and its negative effects on resource allocation (Bonin and Imai 2005; Giannetti and Ongena 2005). On the other hand, research on specific developing countries has shown that foreign-owned banks are less likely to lend to more opaque borrowers and rely more on hard rather than soft information (Mian 2006). Also, the short-term benefits of foreign bank presence are not evident in cross-country econometric studies confined to low-income countries—some studies even report negative effects (Detragiache, Gupta, and Tressel 2005).

Although some evidence suggests that foreign banks might have the potential to transmit shocks from their home countries to their host countries, their lending generally does not decline during financial crises in their host countries (Dages, Goldberg, and Kinney 2000; but see Peek and Rosengren 2001). The withdrawal of some foreign banks from Argentina following the crisis of 2001 might be cited as a contrary case, but there it was the arbitrary and uneven government treatment of assets and liabilities denominated in foreign currency that drove the banks out.

cussed further in chapter 4) have also strengthened these banks' understanding of and capacity to serve middle-market customers in the sparsely populated African environment.

It is hard to be definitive about which ownership structures will work best. Although it is comforting to see clear evidence of changed attitudes from the narrow focus all banks had in colonial times (not least in the more extensive use of senior management staff from the region), it would be naive to think that the return of foreign banks is a panacea for African business. Nevertheless, careful analysis of available quantitative evidence suggests that some concerns about privatization and about sales of key banks to foreign owners have been misplaced or at least exaggerated. Even in Nigeria, where the government divested itself of substantial, albeit mostly minority, stakes in some 14 banks in the early 1990s—mainly through public share offerings to Nigerians (a method that has not been very effective in other countries), profitability was turned around fairly quickly. Beck, Cull, and Jerome (2005) find that, although the government appears to have selected the weakest of its banks for privatization through the public sale of shares, the profitability of these banks—which together accounted for half of the system—reached the levels of private banks and did so without shifting the privatized banks' portfolios into government bonds (even though banks that held bonds in those years found them to be more profitable than lending).

The more recent case of Stanbic's purchase of the Uganda Commercial Bank (UCB) shows even more promising features, according to a new study by Clarke, Cull, and Fuchs (2006). Not only has Stanbic, which integrated the former state monopoly bank into its own Ugandan operation, achieved profitability (greatly assisted by the comprehensive recapitalization of the UCB by the government before sale), but more remarkably, only one branch has been closed, and several previously unprofitable branches have been returned to profitability. Furthermore, whereas Stanbic's lending to agriculture was hitherto below even the average for foreign-owned banks (as was UCB's in recent years), post-merger data suggest that the combined operation may have already expanded agricultural lending to a level that, albeit modest, is comparable to that of other foreign-owned banks. There are other positive signs: an SME business development unit was established, and minimum deposit requirements have been drastically lowered. Still, it is too soon to pass definitive judgment on this case.

To be sure, international banks are not in the business for charity. Indeed, examination of the accounts of multinational banks in Sub-Saharan Africa shows that they have much higher returns on assets and equity than do subsidiaries of the same banks in non-African developing countries. This finding can, in part, reflect a risk premium for Africa. But multinational banks in Africa also tend to be more profitable than locally owned banks. Some of this profitability reflects not only superior products, organization, and cost control, but also the benefits of market power. Most administrative controls designed to curb the exercise of market power in banking tend to have a more damaging effect of limiting access than a beneficial one of restraining excessive profits.²¹ The only viable solution to overcharging is to ensure a policy environment that not only permits entry²² but also creates the conditions under which competitors will wish to enter the market to exploit the dynamic profit possibilities of market growth.

Ensuring a competitive environment will remain a challenge, however, especially as the trend toward banking consolidation continues worldwide. In Mozambique, the dominating position of the largest bank is due to the merger of the parents of the two largest banks in their home market of Portugal. And the acquisition by Barclays of Absa, owners of the Tanzanian market leader National Bank of Commerce, has increased bank concentration in that country. It remains to be seen how the exit of Belgolaise will play out, as its regional subsidiaries are absorbed by other owners. However, bearing in mind how small and fragmented the African markets appear to the major international groups, it may well be that future dynamism in competition will come more from African-owned banks expanding across the continent—and not only from Nigeria and South Africa.^{23,24}

Populist politics often mobilizes support around hostility to foreign banks, and this hostility can create challenges for political leaders who wish to bring the benefits of foreign bank entry to their countries. The banks also do well to use antennae receptive to political sensitivities. The politics of foreign bank entry in Africa is too little understood, as indeed are other political economy aspects of financial sector reform in Africa. For instance, it may well be that a predominantly locally owned banking system (as in Nigeria) could generate a stronger political constituency for wider governance reform, though there is not enough evidence to support this conjecture.

State-Owned DFIs

An earlier generation of policy makers reached naturally to the creation of state-controlled specialized intermediaries to help channel investable resources into development projects. Some DFIs date back to colonial times, and the rationale for their existence has been the perceived market failures in long-term, agricultural, and small-scale finance. Private institutions see these sectors as costly to service and as offering inadequate returns given the risks. The results of state-owned DFI creation were disappointing, and not only in Africa. Although the crisis of the 1980s brought to light deficiencies in all segments of the financial system, these problems were even more pronounced in the state-owned DFI sector. In addition, funding dried up as international donors had second thoughts about the efficiency and sustainability of many DFIs in channeling funds. State-owned DFIs generally did poorly in reaching the ostensible target market, failed to recover loans, and overall imposed heavy fiscal costs. Part of the problem was political interference, part was poor alignment of incentives, and part was excessive intermediary cost structures. Many have been closed; most were downsized.

But state-owned DFIs—even poorly performing ones—have proved to be tenacious survivors. By no means have they all vanished from the scene. Indeed, more than 60 DFIs operate in Africa today. But in many countries, from Tanzania to Zambia to Mali, state-owned specialized banks have remained in a semifrozen situation, largely illiquid and delivering few services, with their solvency precarious and conditional on support from the government.

Why is it that governments have chosen to continue a half-century-long liaison with DFIs? Partly it is because the perceived gaps in the market, whether for housing finance, industrial development finance, or agricultural finance, are still evident. The authorities' reluctance to take decisive steps to sell or rehabilitate these institutions partly reflects the tension between (a) a continued perception that something needs to be done about the market gaps and (b) the fact that putting banks back onto sound financial footing will entail committing fiscal funds that cannot easily be diverted from other uses. That is why many of these entities remain in a state of suspended animation.

Given that this is clearly an unsatisfactory compromise, which way should governments jump: back into the DFI model but with improve-

ments, or somewhere else? For many years now, the World Bank has been generally discouraging on the matter of state-owned DFIs, a fact that puzzles many given that the World Bank itself can be seen as a state-owned DFI, albeit at a global level, and given the sponsorship by rich country governments of regional and subregional development banks.

In fact, the state-owned DFI model sits most uneasily with contemporary understandings of how market-based financial systems work most effectively. This is essentially because—being conceptualized from a planning perspective—the state-owned DFI model blurs crucial differences: between a loan and a grant, between social and private return, and between the promoters' projections and realistic evaluations. It is one thing to embark on a publicly funded development scheme with full awareness and accounting of the risks and uncertainties involved and with politicians taking responsibility for the outlay of public money. Such an approach fits well in a public finance planning perspective. But a financial institution is established with the intention and expectation that it will be a sustainable and self-financing revolving fund. Adding a mandate to make long-term loans with defined social objectives results in a confusion of roles—and a deferral of evaluation that makes it inherently unlikely that both the financial and social returns will be acceptable. The long terms of the investments and the absence of a secondary market for assessing their evolving value makes manager accountability problematic. Even if doubts about the financial soundness of the investment emerge, it is all too easy for state-owned DFI management to hide behind the smokescreen of social justification. By the time failure becomes evident, those responsible have long since moved on. Thus are the conditions for elite capture created.

Those with experience of state-owned DFIs in Africa or in other regions know that this view is not purely theoretical. One case—Nigeria—is explored in box 3.6. Unfortunately, Nigeria is no exception. The Nigerian snapshot in 2000 could be replicated for numerous countries across the continent. Because these stories are not widely understood or because failures have been wrongly attributed to bad luck, public-spirited people still propose the establishment, rehabilitation, or recapitalization of development banks across Africa. In Nigeria a bill to this effect was introduced in parliament early in 2006.

Proximate reasons for the failure of state-owned DFIs are manifold: exchange rate and other macroeconomic shocks; gross political interference (with pressure not only for specific loan recipients, but also for loan

BOX 3.6**One Country's Experience with State-Owned DFIs**

In just one large and well-documented case, the Nigerian DFI sector was found by a Alawode and others (2000) report to present a “relatively dismal financial picture.” Available data for seven Nigerian DFIs (the Nigeria Industrial Development Bank, Nigeria Bank for Commerce and Industry, NEXIM, National Economic Reconstruction Fund, Urban Development Bank, Nigeria Education Bank, and Nigerian Agricultural and Credit Bank) in 1997 and 1998 showed

- A combined annual loss of 9 percent of total assets and accumulated losses of 45 percent of total assets (equivalent in 2000 to about US\$100 million, despite inflation and currency depreciation)
- Negative net worth of 25 percent of assets (even on the optimistic accounting that was used)
- An average of 78 percent of the loan portfolio not performing (for the four DFIs for which data were available)

Several of the institutions had started up in a vigorous and promising manner, but they made poor loans, charged insufficient interest spreads, incurred excessive foreign exchange risks, and never built a strong credit appraisal culture. As nonperforming loans began to spiral out of control, the availability of cash for new lending began to dry up. Even borrowers that could have repaid had a reduced incentive to do so as the prospects of new loans evaporated. Better-qualified staff left.

- By the late 1990s, the Nigeria Industrial Development Bank had stopped lending to its medium- and large-scale clients, more than half of which were losing money or being liquidated.
- Of the Nigeria Bank for Commerce and Industry's book of loans to SMEs, 98 percent had arrears of payments and essentially all the bank's cash flow was going to pay for staff expenses. Even so, management was planning a new head-office building.
- In the export-promotion bank NEXIM, 99.7 percent of its portfolio was nonperforming within six years of its establishment. Actually, much of

(Box continues on the following page.)

BOX 3.6 (*continued*)

its portfolio had been inherited from the Central Bank of Nigeria, which had provided funds for onlending to several banks that soon became insolvent. As with the National Economic Reconstruction Fund, an Apex institution also providing funds to banks for onlending, the weaker banks were attracted.

- The Urban Development Bank, tasked with providing financing for urban development, failed to mobilize external resources and relied largely on its capital endowment to finance the limited investments it made. These investments were priced at between 2 and 4 percent below commercial rates. Difficulties in recovering discouraged the bank from making further loans or investments beyond the 10 percent of total assets that had been reached by 1997. But the Urban Development Bank retained a sizable staff and four offices, leading to administrative costs equivalent to four dollars per dollar lent.
- Possibly the most disappointing case was that of the Nigeria Education Bank, which, seven years after it was established to help finance the higher education sector, had failed to make a single loan, despite employing 261 staff in 21 offices.

Overall, this experience has been one not only of financial unsustainability but of social failure too: by 2000, the Nigerian DFIs had achieved neither their financial nor their development goals.

forgiveness); and inadequate staff skills, often compounded by decisions to underprice lending. But these reasons all come down to the fundamental ambivalence of the model: is the DFI's goal to make profits as a sustainable, market-driven financial intermediary, or is its goal to achieve specified social or developmental objectives?

A publicly sponsored credit guarantee agency is an idea that is increasingly discussed in development banking circles as an alternative way forward, bypassing what is now the conventional avoidance of new DFIs. Credit guarantees of one sort or another are indeed becoming widespread in the financial systems of advanced economies. They include the securitization of credits by banks and their sale in whole or part (typically with some form of credit guarantee attached) to other banks, nonbank financial institutions such as insurance companies, or other managed funds.²⁵

So could this new form of financial technology provide finance for specialized or more risky sectors, where commercial banks seem reluctant to go, or for longer terms than are attractive to commercial banks? The answer to this question needs to be a nuanced one. First, it is important to recognize that many public credit guarantee schemes have embedded hidden subsidies—even Korea’s scheme has been losing approximately US\$1 billion a year in recent years. To the extent that the repackaging of loans puts them into forms that make them suitable to be held in nonbank portfolios, at home or abroad, then (as in the advanced economies) such schemes could have something to offer. However, it may take the development of a more active secondary market to attract really sizable investments by nonbanks. But a second driver of credit derivatives and the credit guarantee business has been regulatory arbitrage. Risks are transferred from entities such as commercial banks, which are subject to prudential regulation, to entities such as managed funds, specialized credit guarantee companies, and insurance firms, which are less tightly regulated or not regulated at all. If the ultimate holders of risk have deep pockets then this may be all right, but if the failure of the ultimate holders feeds back into the public purse through forced bailouts, then the regulatory arbitrage will prove to have been a costly evasion.

By bringing together different participants in the financial market, some recent experiments with credit guarantee schemes have discovered unexploited investment banking opportunities. The Fonds de Garantie Hypothécaire du Mali (FGHM) was established by local banking insurance and government entities with a simple basic objective: to cross-guarantee mortgage loans. Although that remains its basic business²⁶—with an average loan guaranteed of US\$23,000 and a total loan book guaranteed of about US\$20 million—FGHM has found that its staff’s investment banking expertise enables it to get involved in related investment banking-type activities, such as promoting and arranging the sale of a portfolio of mortgage loans. If these initiatives continue to be successful and can be expanded without incurring heavy contingent liabilities for FGHM, perhaps sponsoring and introducing this investment banking expertise into the market will become FGHM’s most important social role and chief contribution to financial development in Mali.

But many DFIs have ended up costing the government a multiple of the capital originally injected (because government provided either explicit or implicit guarantees of the DFI’s borrowings). Similarly, a guarantee scheme

almost automatically triggers very sizable contingent liabilities, in excess of the amount envisaged by the initial explicit investment. The hidden contingent liabilities are far greater than parliament or the general public initially understand. As with state-owned DFIs, the ability to generate these contingent liabilities represents a large honey pot attracting rent seekers.

It is not just that state-owned DFIs failed financially; they also seem generally to have failed to achieve their development goals. Although private sector entities may not have been keen to enter the targeted sectors, they were certainly discouraged from any notion of doing so by the presence of a subsidized competitor. Worse, in many cases no attempt was made to set clear goals for these entities, measure their performance against these goals, and count the cost in a coherent way. For a government operating a DFI now, no exercise is more useful for guiding future policy than undertaking such a cost-benefit review (Yaron, Benjamin, and Charitonenko 1998). As well as informing government decisions directly, a cost-benefit review can have a political economy dynamic. Making the results of these analyses public as a matter of course would provide the basis for a public debate, which could help undermine elite capture of the DFI.

Not all state-owned DFIs have failed in their mission, but the odds of success have been too low. It seems that the DFI model has a good chance of working only if exceptionally strong governance practices and procedures can be maintained and in a responsive and well-informed political environment (box 3.7). This likely explains why more DFI success stories occur in advanced economies, where political, civic, and legal infrastructures to support governance are stronger. Rich countries with strong institutions of governance can afford to risk what is for them relatively small sums on state-owned DFIs. Those countries can absorb prospective losses and deter abuses with the credible threat of sanctions. Multinational development banks, whether at the continental level (such as the African Development Bank) or at the subregional level (such as the East African Development Bank and Development Bank of Southern Africa, or DBSA), also have the advantage of being less dependent on the politics of a single country. But for African countries whose governments are contemplating an expansion of state-owned DFIs, the gamble is unattractive. The scale of potential losses in relation to national income, the poor inherent incentive structures, and the perception that sanctions against abuse are unlikely all make the expected cost-benefit calculation unfavorable for most state-owned DFI initiatives in Africa today. Yet there are some signs of improved

BOX 3.7**Governance Arrangements for DFIs**

Examination of the corporate governance practices of some of the most respected public sector financial institutions worldwide suggests a number of features that are worth trying to incorporate in any surviving DFI, so as to reduce the risk of costly failures. Overall, these features aim to establish a level playing field between DFIs and other financial intermediaries, thereby ensuring that the DFI does not gain a privileged position in some segment of the market that could be provided, perhaps more effectively, by others. In particular, all the standard governance requirements for a private company should apply also to any DFI that the government retains. These requirements relate, for example, to the role and responsibility of the board of directors and its various specialized committees (audit, risk management, remuneration) with respect to financial accounting, auditing, and transparency.

Clarity of the function of each public entity is key. There should be a clear administrative separation of responsibilities within government between the exercise of DFI ownership (somebody must be designated the owner's representative), the exercise of ownership functions for state-owned non-financial firms, and the setting of relevant private sector development policies. Law and transparent, publicly disseminated regulation should clearly

- Identify and delimit the social and public policy objectives of the DFI—that is, the specific elements of the state's ownership policy
- Define the respective roles, responsibilities, and authorities of the governance bodies of the DFI (owner's representative, board of directors, senior management)
- Provide guidance on how the costs associated with the provision by the DFI of social or public services are to be covered
- Specify the nature of any state obligations to recapitalize or to repay the debts of the DFI
- Provide for adequate transparency and disclosure requirements in regard to the performance of the public policy mandate

(Box continues on the following page.)

BOX 3.7 (*continued*)

In addition to the normal financial reporting requirements applicable to any company should be a regular public report on the performance of the DFI in furthering the social and public policy objectives established for it. A performance report requires applying a clear evaluation methodology, using measurable and verifiable social and public policy outcome indicators. It also entails a clear statement of the nature and extent of any state financial assistance, including, for example, subsidies, tax concessions, or guarantees.

Some African DFIs have begun to assess their governance arrangements against these or similar criteria. However, the effectiveness of such procedures depends crucially on a sufficient segment of the public being financially and economically literate, on the ability and willingness of the press to inform public opinion, and on the responsiveness of the political process. These prerequisites are not yet widely present in the region.

Source: This text draws on unpublished notes by David Scott.

governance on the continent; perhaps in time the need for health warnings about state-owned DFIs will diminish.

Given that the private market does not function very well in these difficult sectors and yet it seems difficult to reliably overcome the governance and political interference challenges that have marred the performance of so many state-owned DFIs, what is the safest and most promising way forward in African development finance today? Can existing state-owned DFIs be rehabilitated with private ownership participation, diversified lending products, or more dependable sources of local currency? Proponents are already experimenting along these lines. For example, Johannesburg-based DBSA—which has been active in the rehabilitation of DFIs in neighboring countries—is optimistic, even though its management understands that success with these ventures depends crucially on ensuring adequate governance. In some cases, the move to private control has meant a shift toward commercial banking, as with the DFCU Group in Uganda, the Development Bank of Kenya, and, to an extent, Austral Bank in Mozambique. That shift may imply commercial survival of the intermediary but, if taken to extremes, can result in an institution that is a development bank only in name.

More generally, private banks might be willing to enter some of the difficult segments if they are not undercut. Indeed, development banking, in the sense of banking that is focused on longer-term objectives with particular attention to creating social benefit alongside profitability, could be viable for a private investor (or for external development partners, a point taken up again in chapter 4). But in addition, nonbank finance could play a larger role in filling the term- and risk-finance gaps in a sustainable manner.

One good rule of thumb seems to be that publicly financed development banking initiatives are more worth trying if the downside risks are limited. Investment banking services that arrange and broker deals without taking major positions (as in the Mali example) can fill a knowledge gap that undoubtedly exists today in most African financial markets. The limited and manageable subsidies that might be required to launch investment banking firms with such a remit could be well rewarded. This could happen if the firms successfully (a) attract foreign or local venture capital, (b) advise on the financing aspects of public-private partnership (PPP) infrastructure deals, or (c) catalyze market development and new instruments for mortgage finance and, more generally, for bringing together potential providers of long-term or risk finance, at home or abroad, and users—especially in productive sectors that have export potential in the long run.

Term Finance and Risk Finance: Beyond Commercial Banking

The preoccupation with long-term finance that has driven much of the interest in DFIs is not unique to Africa but has been seen down the decades in country after country. Of course not only long-term finance is needed; even export and other trade financing can be scarce and costly in Africa. But there does seem to be evidence that access to medium- and long-term financing enhances firms' growth prospects (Demirgüç-Kunt and Maksimovic 1999). Although we cannot point to much quantitative evidence that the long-term lending situation in Africa is particularly difficult, it is certainly true that long-term finance is far from plentiful. Indeed, in few countries do banks routinely extend loans with maturities beyond three years, even for high-quality borrowers. And, as shown by the survey data reviewed in chapter 2, to the extent that enterprises use the financial system for external financing, it is to banks that they mainly turn.

Yet many productive investment projects, especially in infrastructure, capital goods, or housing stock, are best financed with long-term funds involving maturities of 5, 10, or even 20 years. This is because, although they produce high rates of return and can service and repay significant amounts of debt in the long run, they cannot repay investments out of the cash flows generated within the short-term financing horizons offered in African markets. They require loan repayment profiles that match the long-term cash flow profiles. Of course, some borrowers, finding that lenders will not grant long-term loans, proceed on the assumption that their current borrowing facilities will be rolled over, but all too often the refinancing risks are just too high for the project to go ahead. In housing finance, most middle-class households in Africa could service and repay sufficiently large mortgages to develop adequate housing, if amortization were to be spread over a long enough horizon to reduce monthly mortgage payments to serviceable levels.

It is easy to see why long-term funds may not be as forthcoming as short-term funds. From the perspective of the provider of funds, long-term lending is riskier than short-term lending. Uncertainty and lack of information about the future loom larger. As long as contractual repayments are being met, the long-term lender forgoes the ability to take control or to influence the borrower to take corrective action if the risk of default seems to have increased.

Also, the provider's own liquidity is placed at risk.²⁷ A bank may recognize that most of its nominally short-term deposits are in practice highly stable, but this stability may depend on macroeconomic conditions. If there is a surge of withdrawals, African banks may not have liquid money markets on which to draw in a hurry. Thus, although the transformation of short-term deposits into longer-term loans is at the heart of conventional banking, the willingness of African banks to push this maturity transformation very far is limited, even where they are not restricted by regulation.

Access to formal risk equity financing is even scarcer. To be sure, retained earnings finance the bulk of working capital needs as well as expansion capital. They are a form of equity, but there is little recourse to public issues, and the organized equity markets are small and inactive and of interest only to a very limited number of large companies, multilaterals, and financial institutions. Private placements are largely on an ad hoc basis. To the extent that other entrepreneurs secure outside equity, it is from such informal sources as relatives, friends, or community members.

Part of the problem for equity finance is the difficulty that the outside equity holder has in monitoring the firm's performance. Perhaps the insiders have found ways to channel much of the true profit of the firm to themselves and their associates, effectively expropriating the outside equity holders of their equity. These monitoring problems are pervasive in equity finance worldwide, but they are worse where information is scarce and unreliable, as in many parts of Africa.

Yet African markets have natural providers of long-term funds and of equity funds. Some are foreign based, and we will have less to say about those. But the elements of the local financial markets have not yet performed in this dimension as they could. Institutional investors, organized securities markets, and certain specific instruments and innovations related to housing and infrastructure finance that can help so far tend to be underprovided in current African conditions. They are briefly reviewed below.

Pension Funds and Other Institutional Investors as Natural Providers of Long-Term Financing

An exception to the general rule that most providers of funds are reluctant to go long-term relates to pension and social security funds. Although such funds are not entirely free of the concerns that discourage other investors, they do have a natural affinity for long-term instruments because the maturity of their liabilities is also long term. Given a rapidly growing population and formal workforce, broad-based social security and government employee pension funds in Africa often have sizable and growing sums that need to be invested for a long term.

At the same time, there is a degree of concern about the actuarial viability of many of these funds. The doubts may relate to the parameters of the underlying schemes, with promised pensions or other benefits that are too generous to be affordable at current rates of contribution. In addition, collecting contributions is not always very effective, and even those who have a very broken contribution record may be able to claim a pension in due course—and if they can, they certainly will. Rising death rates related to AIDS also complicate evaluation of the solvency of pension funds. Depending on death benefits, an increase in early deaths of scheme members may improve or worsen the solvency of the funds; furthermore, death rates may peak in the years ahead, reversing the effect. On the asset side, past

investment policies have often seen an erosion of value instead of market-related returns. Investment in low-yielding government securities, losses of real value caused by unexpected inflation, deposits frozen in insolvent commercial or development banks, and other failed investments have been all too common. The poor investment returns often reflected mandates by cash-poor governments and to that extent reflect more a divergence between a stated funding policy and an unfunded reality, not dissimilar to the pay-as-you-go schemes in some advanced economies. Sometimes they reflected other types of poor governance of the funds.

Even a scheme in actuarial deficit, though, is likely to generate substantial surpluses for the next couple of decades in most African countries. Therefore, the effective maturity of its liabilities will be long term. For the present, then, these schemes have sizable sums to invest for the long term; to the extent that these funds are not channeled into funding the government deficit (as they are in the United States and many other countries), they could be available to augment long-term investable funds in the financial market.

An increasing number of social security funds are moving from the defined-benefit model—sometimes unfunded—to a fully funded defined-contribution scheme. One of the expectations of the reformers behind these schemes is that such reform will result in more long-term savings for investment. Yet even when they are being managed at arm's length from the government's fiscal managers, too many of the investable funds of pension and social security schemes are still being placed in short-term bank deposits or short-term government papers. This can be seen, for example, in Senegal and Uganda (see table 2.3). In effect, many countries—and not just in Africa—suffer to a degree from reverse maturity transformation.

The potential for institutional investors to expand the availability of long-term funds is not being realized for various reasons. In some cases, investment restrictions imposed by prudential regulation or policy unduly restrict the scope of pension fund investment policy. Managers of large pension funds do experience pressures from those who seek an easy route to long-term financing of their projects. The challenge is to ensure that governance of these funds is adequate. In advanced financial systems, most of a pension fund's assets can be marked to market, thereby providing interim evaluations of the quality of investment decisions. That is not possible with unlisted equities in a less developed market. Perhaps that is

why, when they do move away from bank deposits and government bonds, pension fund managers in many African countries tend to favor property. Property is visible and easier to value than private equity or, indeed, large loans to unlisted companies, let alone more complex instruments such as asset-backed securities. This is where organized securities markets can help anchor and benchmark investment strategies and contribute to the evaluation and maintenance of quality governance.

As well as directly investing, pension funds and others with long-term resources should be willing purchasers of packages of mortgages or mortgage-backed bonds or other long-term instruments arranged by or through intermediaries that do not themselves have long-term resources, such as commercial banks or investment banks. Indeed, the scope for the investment banking skills needed to bridge the gap between pension funds and ultimate borrowers is considerable.

Other forms of institutional and managed funds can also play an increasing role in African term and risk finance over time. The insurance sector in Africa is still small and dominated in almost all countries by nonlife business, with life insurance just beginning to develop. In addition, a number of collective investment schemes have recently been licensed throughout Africa but are not significant market players yet. A handful of foreign institutional investors have been active in African markets and should be seen in a positive light not only because of the investment funds that they import, but also because of the technology transfer that can result from their activities.²⁸ Experience in other parts of the world suggests that foreign direct or portfolio investors are unlikely to be the most significant contributors to macroeconomic or capital flow volatility. Instead, foreign direct investment (FDI) will be a crucial catalyst in boosting African growth on a sustained basis.²⁹

Securities Markets as Catalysts of Long-Term Financing

Organized securities markets could play a key role in facilitating the flow of long-term and risk finance from institutional investors and others to productive enterprises in manufacturing, agribusiness, services, to utilities, and—indirectly—to middle-class house purchasers. But this potential has scarcely been realized to date in Africa.

Despite a considerable pickup in activity, listings, and funds raised in the past few years, it remains true (as described in chapter 2) that, the Johannesburg exchange aside, the 14 exchanges in Sub-Saharan Africa display a

low level of equity trading and limited raising of new capital. Nigeria is the most active of the other markets; a flurry of issues there is connected with the increased minimum bank capital. Some of the listed companies have sourced sizable funds for expansion from equity issues, as documented, for example, in Amo Yartey (2006). Overall, though, most of the larger listings in recent years have arisen out of privatizations, tax incentives,³⁰ mandatory listings for banks, and what might be called vanity listings by multinational or regional firms.

The last category requires explanation. A *vanity listing* is the issue of a relatively small fraction of the equity of a local subsidiary in a context where the parent has no need for the resources that will be raised. Some vanity issuers see such listings as a publicity device, as well as a way of both signaling commitment to the host country and establishing a potential lobby group of local shareholders that may act as political insurance. Other similar listings are a historical legacy: In 2004, Guinness Ghana bought 99.6 percent of Ghana Breweries, but the latter remains a listed company. Local listings allow such firms to offer remuneration to workers in the form of stock (as, for example, with Compagnie Ivoirienne d'Electricité, 69 percent of whose shares are held by a large French utility group). One way or another, foreigners own a sizable proportion of the shares on most of the exchanges, and most of these proportions are strategic stakes. Even in Nigeria, the foreign-owned share is put at just under one-half.

These are reasonable ways for an exchange to begin life. Even vanity issues can provide useful savings vehicles for domestic institutions.³¹ But so far, the lack of significant secondary trading in most shares limits the liquidity of shareholdings and means that prices on the exchange are unlikely to represent a reliable indicator of the true value of a block holding of the shares. Besides, most of the shares are effectively locked up in controlling or strategic stakes and are not available for sale.

Bond issues have until recently been few and in some exchanges have required third-party guarantees, with the result that they too do not allow the market to reveal a consensus value on the debt of the issuing company. Although some markets do list medium- and long-term government bonds, in most countries they are still not issued with sufficient regularity to a sufficiently broad investor base or with a sufficiently low perceived default risk to allow the market to establish a reliable yield curve for the national currency (that is, a set of default-free interest rates for different maturities).

In short, the paucity of securities and the lack of trading activity limit the ability of most of these markets to provide a platform for price discovery and benchmarking of other securities. Transaction volumes do not justify investment in technology by either the exchange or member brokers. Limited trading discourages listing and raising money on the exchanges. In a form of vicious circle, the limited number and small size of transactions raise, in turn, transaction costs.

It is in these dimensions that strengthening of the stock markets needs to be envisaged. It may be that too much emphasis has been placed in recent years on building costly regulatory regimes designed to ensure a high level of protection for the retail customer in the secondary market. Such regimes represent a substantial up-front investment, partly in systems and infrastructure but mostly in processes, legislation, regulation, and supervision. Although the technology costs of a basic trading platform have fallen,³² the more substantial costs and administrative challenges of establishing an operating environment conducive for an exchange have, if anything, increased. These fixed costs make sense in a market with heavy volumes but are not so easy to justify for a start-up market. They lead to high costs, which in turn limit volumes even further. Compliance costs are also potentially high.

The success of the model of regulation that has been adopted depends on a high degree of efficiency in regulation and governance. In the absence of a dependable environment (including accounting standards, supervision, and enforcement), the investment in legislation, regulation, and processes is stranded. The regulatory and judicial regime is not, in many cases, capable of identifying and punishing offenders, and it is therefore likely that compliance is in fact low. Besides, in practice, the main actual and prospective investors in most African equities and bonds are likely to be relatively sophisticated and may not need or benefit much from such protection as the regulatory system can truly provide.

Market architecture should be chosen on the basis of local needs and capacities. It may well be that most African firms would be better served by a lighter regulatory approach, along the lines of "second boards" in advanced economies. The emphasis would be on increasing primary market issuance more than on high-frequency trading efficiency. A lighter regulatory approach, one step beyond the private equity and over-the-counter markets, can work to an extent on the basis of caveat emptor, with the sophistication of analysis resting with the investor.³³ Reg-

ulations (for filing, disclosure, and corporate governance) would, of course, exist, but they would be designed with a light touch and chosen in such a way as to be relatively easy to enforce. Some regulators, such as the UK Financial Services Authority (FSA), are already mandated to conduct a benefit-to-cost assessment of all new regulations. And even in the United States, a high-profile committee has recently reported on the need to establish more cost-effective ways of furthering the goals of good governance and transparency, especially in regard to smaller companies (U.S. Securities and Exchange Commission 2006).³⁴ Similar sentiments should guide African regulation also, but with even greater force.

Several African exchanges—Ghana, Nairobi, Nigeria, and Bourse Régionale des Valeurs Mobilières (BRVM) in West Africa—have multiple listing segments that differ, for example, by permitted ownership concentration and prelisting profit record. The suggestion here is that the second-board model could be the main regulatory approach for small African exchanges rather than being an add-on. Also, in contrast to several second-board markets in advanced economies, which have focused on rapid-growth or high-tech companies, the goal in Africa would be to target small and medium-size companies in general.

Doing so would offer most firms a low-cost market at home. Their offerings on such a market, albeit more lightly regulated, would still appeal to local institutional investors, who would expect a return commensurate with the risks taken. It is not that the tougher requirements are useless—indeed, tighter listing requirements and regulations can increase market liquidity and prices, as has been shown for larger markets. But they result in a compliance cost barrier that shuts out too many African firms that could benefit from outside equity.³⁵

For larger companies—able and willing to genuinely establish high governance and transparency standards in order to benefit from a lower cost of capital and to reach a wider international investor clientele—listing on advanced markets such as the Johannesburg or London exchange represents a viable alternative. Mention has been made in chapter 2 of the extent to which larger South African companies have their primary listings in advanced economy exchanges such as those in London, Luxembourg, and Australia.

The migration of the larger companies to international markets is a process that has been experienced worldwide. If such companies raise lower-cost funds abroad, that could leave more funding and more home

investor interest for smaller firms that are not at present served. Trading tends to concentrate in the most liquid market, so it is not surprising that the migration of listings can result in lower trading at home of the migrated companies. Indeed, where such migration has happened from previously active markets, some loss of overall liquidity has been observed (Levine and Schmukler 2006). But Africa's exchanges are at a stage from which they can only improve.

This two-tier approach—low-cost local markets for the smaller firms, access to major markets abroad for the larger firms—could be an alternative for or a complement to an expansion of the concept of a regional securities market. The prospect for regional unions of exchanges is discussed later.

Other complementary policies are needed if securities markets are to flourish. They include a stable and predictable tax environment. Furthermore, stock exchange participants will need to start thinking in terms of fostering smaller companies as their future client base by promoting business advisory services. Ultimately, the optimal strategy for developing organized securities markets in Africa will ensure that firms have better access to patient capital. It will not necessarily entail a local securities exchange whose sophistication may act as a barrier to entry for local enterprises in attracting capital.

Long-Term Finance for Housing

Although the lack of well-functioning mortgage markets is far from being the only cause of poor housing quality in Africa, better availability of long-term housing finance could greatly improve housing quality as well as provide a useful outlet for long-term funds. Housing finance can make a lumpy investment into the building, renovation, or expansion of a house more affordable by spreading the costs over time. It can also provide a suitable investment to match the long-term liabilities accumulated by pension funds and insurance companies.

Many middle-class African households have stable and secure incomes and could afford to service long-term mortgages that are sufficient to pay for good housing. Instead, the very limited availability of long-term mortgage finance leaves far too many in the unsatisfactory situation of having to improve their housing only on a "build-as-you-earn" basis, with the inefficiencies and deferrals that that entails.

As documented in chapter 2, most African financial sectors lend very little for housing. If housing finance is available, it is mostly limited to the upper classes and expatriate community. At the other end of the spectrum, as mentioned later, microfinance clients may have access to loans that can be used to improve their housing. It is in the large gap between these two segments that development of the mortgage market can help.

Numerous impediments hold back housing finance in Africa: macroeconomic instability, deficient property rights systems and markets, and lack of proper funding mechanisms. Although damaging for most financial contracts, high inflation is ruinous for the mortgage market. It tends to frontload repayments (with high nominal interest rates required to compensate for expected inflation), making the servicing charges very high in the early years. It can also erode savings and exacerbate financial uncertainty. However, inflation is not the principal barrier to mortgage market development in most African countries today. Long-term finance for housing is typically constrained both on the origination (primary) side and on the funding (secondary) side. Financial institutions are reluctant to extend long maturities to mortgagees because of the weak lending and operational framework. Furthermore, they cannot themselves access long-term financing.³⁶

Primary mortgage markets are constrained by inadequate legal and institutional frameworks. Weak legal protection of secured lending and weak enforcement of collateral, incomplete land titles and registration, land transfer restrictions, insufficient credit information on retail borrowers, and lack of building standards and valuation procedures limit the ability of financial institutions to provide long-term finance for housing. In addition, deficiencies in the supply chain often make housing prices unaffordable. In particular, inefficient mechanisms for financing and delivering primary infrastructure make the costs of land development prohibitive. Furthermore, small markets with few transactions reduce the value of collateral and lending costs for banks.

Despite those impediments, lenders in several countries have entered or aggressively expanded the housing finance markets. Banks in South Africa have committed to expanding housing finance to low-income households and have started offering housing finance products targeted to that market. Donor-financed financial institutions, such as the DFCU Group in Uganda, have entered the middle-income housing market. With the aim of stabilizing funding resources, Banques Populaires in Rwanda and Nye-

sigiso in Mali as well as other microlenders in West Africa have introduced housing-related savings products in the French style.

Another important impediment to long-term housing finance is the lack of long-term resources. Mortgages in most countries, including European countries and the United States, are still funded chiefly through deposit resources. However, this method requires a reasonably stable deposit base and the opportunity for banks to manage liquidity using inter-bank and repo markets. But there has been increasing interest in employing secondary markets to fund long-term housing loans. One approach is a market in fully securitized mortgage bonds, or at least a market for mortgage-related bonds. Developing an adequate framework for selling and trading securitized mortgage packages is challenging. Given the lack of organized exchanges and the high listing costs and limited trading on such exchanges as do exist, full securitization may be difficult or at least premature in most African countries. Instead, banks and other mortgage originators are likely to achieve similar benefits with lower setup costs by issuing mortgage-related bonds, which are secured by priority claims on the mortgage portfolios on the bank's balance sheet, or similar types of securities. Pension funds and insurance companies would be the prime candidates to purchase such bonds and provide the necessary funding.

Second-tier liquidity facilities, which use proceeds from bond issues (often with partial support and risk sharing by governments or donors) to refinance primary mortgage issuers, have proven an effective alternative for providing long-term finance in many countries. These and other forms of public facility—such as take-out guarantees with adequate financial backing to support long-term funding instruments—can signal government commitment to maintaining a sustainable macroeconomic policy framework. However, if introduced too soon and without adequate governance, they risk generating a dependence of the type familiar from the experience with housing and other DFIs in the past, which conspicuously failed to meet housing finance objectives over the years.

Helping the market develop the necessary funding mechanisms is a more promising approach than previous attempts to provide housing finance directly through state-owned intermediaries. Numerous such institutions (in Cameroon, Rwanda, and Tanzania, for example) have failed both financially as well as in reaching their target clientele. Similarly, creating a funding base through a compulsory savings scheme, as in the case of the Nigerian National Housing Trust Fund, can result in below-market

remuneration, nontransparent management of savers' funds, and lengthy borrower waiting lists.

Many households are too poor and lack sufficient creditworthiness to be granted long-term mortgages of sufficient size to pay for a whole house. In such cases, improved step-by-step financing remains a feasible middle course, as discussed in chapter 4. Remittances play an important role in financing housing developments in many African countries. Microlevel surveys in countries such as Ghana and Nigeria suggest that a significant share of remittance flows is channeled into housing construction. Linking remittances with functioning mortgage markets by leveraging them as equity in support of mortgage loans could play an important role in kick-starting housing finance in recipient communities. Developing payment systems and products to provide incentives to make a larger share of informally transmitted remittances available for intermediation in the formal financial system will contribute toward improving the efficiency and effectiveness of remittance finance for housing development.

Innovative Financing Instruments for Infrastructure

The domestic financial system could play a larger role in financing infrastructure, whether by investing in infrastructure-related bonds or by participating in the financing of PPPs in infrastructure.³⁷ Given their high capital intensity, long time to cost recovery, and relatively predictable cash flows, infrastructure projects provide a natural investment opportunity for long-term savings. By financing infrastructure, local institutional investors can help avoid reverse maturity transformation and improve the risk-return profile of their portfolios.

Local-currency financing of infrastructure may also be a better match for the flow of benefits or service charges, resulting in reduced risk for the lender and a more predictable servicing burden for the provider or user of the infrastructure. Depending on the tariff regime, lower financing costs can ultimately translate into lower user fees.

Depending on whether infrastructure provision is by a public authority, a privately owned utility, or a PPP, a range of financial instruments can be envisaged. Public funding solutions for infrastructure include infrastructure bonds. Depending on the government's general creditworthiness, these could be more attractive than conventional government bonds if backed by a dedicated source of amortization from user fees or earmarked

taxes. If a privately owned utility or PPP³⁸ is involved, unsecured corporate bond issues and initial public share offerings by existing utilities can provide local-currency financing for their domestic costs while equally developing capital markets through new investment opportunities. In addition, securitization of existing utilities' revenues could provide an alternative source of funding in capital markets with a robust legal framework.

The contribution of domestic financial markets to infrastructure finance has been limited to date in Africa. Government and private project sponsors have brought their own financing or have borrowed from international banks. Only a few infrastructure bonds have been floated on domestic capital markets—mainly for the telecommunications sector, where investments can be recovered more quickly, prices are often not regulated, and markets have significant upside potential.

Both sides of the market will need build up relevant investment banking skills if more ambitious domestic financing solutions are to succeed. It may be realistic to begin by funding existing creditworthy utilities before attempting to finance greenfield infrastructure projects.

One problem is the lack of a long-term yield curve against which to establish a realistic price for the bonds. But even more important is the limited ability of banks and institutional investors to analyze, structure, and monitor long-term project risks. Among these risks are a variety of political and regulatory ones. In most African countries, regulatory regimes for infrastructure are incomplete, and future tariff regimes are therefore uncertain. In addition, there may be a high credit risk for projects that depend on government off-take arrangements.³⁹ Significant technical and commercial losses resulting from fraud, nonpayment, and the absence of metering technologies increase commercial risks. Of course, the whole point of tying the bond to the infrastructure project is to achieve an improved sharing of these risks, but this may be hard to do when the risks are difficult to evaluate.⁴⁰

As with mortgage-related bonds, investors are more reluctant to buy long-term instruments where no liquid securities market provides them with an exit in case they need liquidity. This situation has led to suggestions that a public liquidity facility might be set up to provide a refinancing option with an interest rate cap, mitigating long-term refinancing risk. The facility could also be used for bank loans after an agreed maturity and could equally provide take-out financing for private equity investors after their initial investment horizon. However, such arrangements entail siz-

able contingent risks for the public authorities and require careful structuring in order to preserve a reasonable balance of risks and to protect the public interest. The application of investment banking and public finance economic evaluation skills in devising and evaluating all such initiatives is crucial if the public interest is to be well served.

Macroeconomic Aspects: Building Confidence and Absorptive Capacity

The ability of national financial systems to function effectively is strongly conditioned by macroeconomic conditions at home and by fiscal pressures on financial markets. And their effectiveness is, or can be, influenced by the wider regional environment, especially where intergovernmental regional cooperation is in place.

Macroeconomic Benefits and Barriers

If current efforts to strengthen the lending ability of domestic financial systems are successful, the incidence of chronic excess banking liquidity will diminish. Furthermore, deeper and more efficient systems will then be able to help economies absorb what could be a growing flow of investable resources from the doubling of aid that has been promised—together with a return onshore of savings now placed offshore—without succumbing to Dutch disease.⁴¹ Instead of simply routing the additional resources that they mobilize into foreign placements or government securities, banks will find it advantageous to onlend them prudently to borrowers whose investment opportunities will spin off wide-ranging benefits to the economy at large. The resulting increase in productive capital will help ensure that the inflows do not create inflationary pressures and that their expansionary effect does not have to be choked off through excessive increases in policy interest rates. The growth effect of such inflows will then be much more lasting.

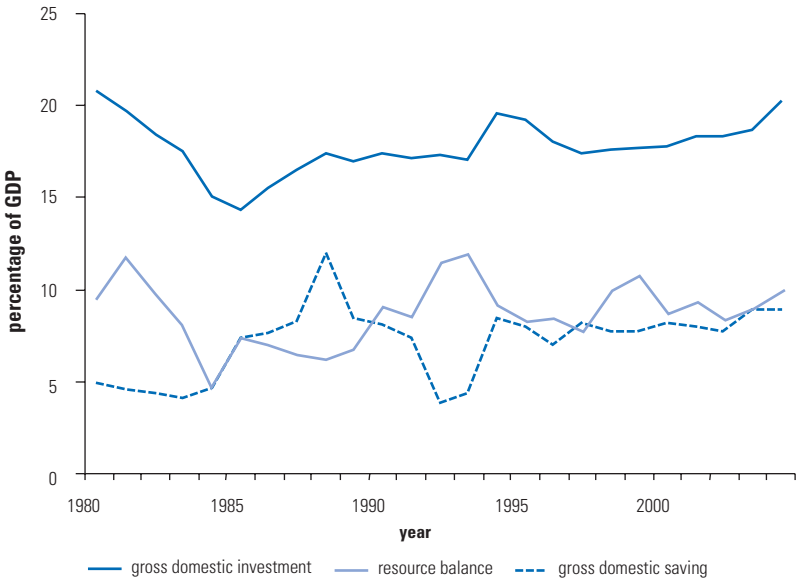
Indeed, if the effectiveness of financial systems in intermediating funds increases as it should, the relatively low domestic savings rates in Africa and the placement of such large funds both offshore and in foreign-currency deposits onshore will become an increasing constraint (Aryeetey and Udry 2000). After all, most African countries already rely heavily on

foreign savings to augment a meager domestic savings rate. The savings ratio (gross domestic savings as a percentage of GDP) for the median African economy has averaged only 8 percent for the past decade, without much sign of an increase. Indeed, in aggregate, foreign transfers and borrowing (mostly aid but also recently including private capital inflows) have financed as much of gross domestic investment as have domestic savings (figure 3.5). In contrast, for low- and middle-income countries across the world as a whole, domestic savings have exceeded domestic investment in every year for the past three decades.

Stabilizing Wholesale Financial Markets

Broad confidence issues permeate all discussion of how to stabilize the performance of wholesale financial markets in Africa. Africans’ relatively large external holdings of bank deposits can partly be traced to confidence factors.⁴² High yields paid on government bonds denominated in local cur-

FIGURE 3.5
African Countries: Saving and Investment as a Percentage of GDP



Source: World Bank’s World Development Indicators database.

Note: The figure shows the median of African countries. Resource balance is the difference between investment and saving.

rency also reflect the fear that repayment difficulties will result in delays, special taxes, or sudden devaluation, as does the growth in the dollarization of bank deposits (see box 3.1).

The perceived systemic risk in African countries is high. It is not only a question of the natural hazards (discussed in chapter 2). Instead, political risk seems to dominate. As just one example of current external perceptions, African countries score an average of 4.5 on a political risk rating scale of 0 to 7 produced by the Belgian export credit agency. This score contrasts with an average of 2.4 for the rest of the world.⁴³

The most important lines of solution to these difficulties lie in dimensions that go beyond the scope of this report, covering not only fiscal management but more broadly the functioning of political and social institutions of governance. Nevertheless, a number of relevant elements lie within the scope of financial sector policy. It is appropriate to mention two briefly: management of the domestic government debt and financial policy responses to aid fluctuations.

Management of government debt

Quite apart from its direct impact on government indebtedness, the cost of capital, and vulnerability to shifts in confidence, excessive reliance on domestic government borrowing has a corrosive effect on incentives for banks. It becomes too easy for them to make short-term profits without having to exercise their credit appraisal skills. Thus, such reliance hampers the flow of funds to productive uses. It can also leave banks vulnerable later when rates come down again, resulting in a boom-and-bust cycle. But a coherently planned, moderate, and managed program of government borrowing through the issue of bonds in a transparent market can help build infrastructure that can support private bond issues also.

Investors in African financial markets are typically considered risk averse—a phenomenon long observed (see Austen 1987). Lacking trust in the sustainability of macroeconomic reforms, market participants maintain conservative risk practices. Building confidence in the stabilization of fiscal and macroeconomic policies is a key challenge for reform-oriented policy makers. This learning process benefits from transparent and predictable monetary policy frameworks and clear rules and procedures. Communication of monetary policy targets, provision of reliable market information, and coordination between key government agencies such as the debt management office, central bank, and budget office are crucial

steps in preventing unnecessary market shocks and surprises that hinder investor confidence.

Especially in the initial phases, while confidence is still being built, variable rather than fixed interest rates are more likely to appeal to investors in longer-term financing instruments. Long-term infrastructure bonds, discussed previously, can be a very useful means of lengthening maturities.

With confidence increasing, the government debt manager can standardize the bonds that are being traded in the market and concentrate on a few key maturities, establishing a stable and representative yield for the highest-quality bonds at these maturities. This yield can then serve as a reference rate not only for the issuance of private bonds, but also for all sorts of present and future value calculations that are made in the economy. This is what is meant by establishing a yield curve.

In some environments, inflation-indexed instruments could offer attractive protection for pension funds and other long-term investors. Inflation-indexed instruments are most useful where borrower cash flows or security provide a natural inflation hedge like real estate, capital investments in the retail sector, or infrastructure products with strong local cash flows.

Surges in aid and other external flows

The promised doubling of overall aid to Africa will present absorption challenges that can be tackled successfully only if the structural strengthening of domestic financial systems is achieved. Furthermore, the flows are unlikely to increase in a smooth manner. Aid has already been a quite volatile element in the balance of payments of African countries. There have been surges in aid flows, often associated with a change of government or policy orientation or with a postconflict situation. Inflow surges in individual countries are likely to become more common with the increased overall flow of aid. These surges can create challenges for aggregate credit policy.

Aid is not the only source of inflow volatility. Export quantities and prices have also caused booms and busts in the past, often poorly managed. The latest of these is now benefiting petroleum-producing African countries. Private capital flows can also be volatile—as seen in particular episodes affecting Kenya and South Africa, for example. Most of Africa has not experienced such episodes, though, reflecting the minor importance of inward portfolio investment stocks.

There is no mechanical rulebook for quantifying the optimal response by the fiscal and especially the monetary authorities to surges in inflows. But the problem is not as mysterious as it is sometimes made out to be. The first question for the monetary authorities can be boiled down to asking whether the surge is likely to be associated with an increase in the demand for real money balances. If it is, this increased demand should not be choked off by aggressive policy. If it is not, then the relaxed monetary conditions that will result from an accommodating approach will likely result in some combination of inflation, currency depreciation, and current account payments deficit. Mechanical adherence to fixed quantitative targets for the monetary and credit aggregates is not an adequate response. More promising is an “inflation-targeting lite” approach, in which active feedback from market developments allows the shifting demand for money function to be accommodated, thereby ensuring avoidance of mistakes on either side. This approach should ensure, on the one hand, that the flows are not oversterilized by interest rates being pushed up, thereby hampering the output and development response, and, on the other hand, that temporary surges are not allowed to splash into unsustainable spending patterns (box 3.8).

Regional Collaboration

We have already mentioned the potential for regional collaboration in banking and insurance supervision and in securities market trading and governance. Other possible areas of collaboration include accounting and auditing, credit information, payments systems, and—of course—a common currency. Initiatives have been taken in all of these areas and more. Some have been up and running for decades, especially in the CFA zone. Three key questions must be asked about each new initiative in this area: Will it reduce transactions costs? Will it increase effectiveness and enhance confidence by effectively increasing the independence of the regional institution from national political pressures? What countries should be included? These questions await definitive answers, but several considerations need to be kept in mind:

- First, some forms of financial service can cross borders without the need for an elaborate supranational or multinational regulatory structure to govern them. The proliferation of cross-border banks in Africa illustrates how market firms may be prepared to negotiate the costs of work-

BOX 3.8**Surges in External Inflows and Implications for Financial Stability**

Sudden changes in the level of aid flows or other external flows (such as payment surpluses now being generated for oil-producing countries by the exceptional levels of oil prices) present issues of macroeconomic and monetary management and demand improvements in intermediation capacity.

To the extent that aid flows and oil money are directly spent on imports without adding to domestic demand, no evident macroeconomic consequences may occur. But more generally, if aid money implies an increase in domestic spending, a sustained increase in such flows implies that the rest of the economic system will adjust—in particular, key variables including real interest rates, income, and exchange rates. Literature on the subject is extensive: the issue arises even in a model as simple as that of Mundell and Fleming, as well as in models of the Dutch disease; for a recent analysis applied to low-income countries, see O’Connell and others (2006). Nonetheless, it is not sufficiently widely recognized that these adjustments need to be taken into account in adapting monetary policy to the new equilibrium.

The equilibrium adjustments of real interest rates and real income (increases) and the real exchange rate (appreciation) that will be needed to clear domestic goods, money, and foreign exchange markets in response to a sustained surge in inflows could be sizable. Their size will depend in particular on the marginal propensity to import out of increased income, the price elasticity of imports, and the interest sensitivity of money demand. If either or both of the first two are high—which is likely in many African countries, though precise and reliable estimates are not generally available—the equilibrium changes will be small. Nevertheless, they will have an effect on the demand for real money balances.

From the point of view of monetary and credit policy, clearly the goal should be to accomplish the adjustment without any impact on inflation. Doing so implies, for example, that the planned growth path of nominal monetary aggregates—including the target for reserve money—should be compatible with the preexisting intended path of prices and the new equilibrium money demand.

(Box continues on the following page.)

BOX 3.8 (*continued*)

In practice, none of these magnitudes will be known with precision. Nevertheless, an intended (target) path for reserve money, corresponding to the planned inflation rate, and an expected path of interest rate and exchange rate should be calculated in accordance with the best information available. Then, as events unfold, the deviations of actual from expected can be fed back into the model underlying the original forecasts in order to revise the parameters. Higher inflation or a lower-than-expected interest or exchange rate appreciation would signal the need to tighten the reserve money target, and so on. The monetary targets thus need constant attention in case the demand for money and other relevant relationships should prove to be different than what was expected. Mohanty and Turner (2006) and IMF (2006) discuss these issues in the current African context further.

ing in multiple jurisdictions in order to expand their operations into a wider market. These developments may add to the complexity of the supervisor's job, but the point is that they can happen without being pushed by a cooperative international effort by public authorities.

- Second, even when considered together, the economies and financial systems of most groups of African countries are still small. To achieve a deep and efficient financial system, African countries really need to think of integrating more into the global financial system—not just with their neighboring countries. Cooperation among African regulators and financial trade with neighboring countries can be very valuable, and an understanding of regional conditions means that such dealings are the most natural places to start. But they do not fully solve the problems of small scale.
- Third, it could be a mistake to transplant in an unthinking manner ideas that work in the European Union (EU). The smooth functioning of governance and judicial infrastructures that underpin the operations of the EU cannot at present be ensured in all African regions. Furthermore, the delicate balance of power between large and small nations that has been maintained over the years in the EU may be difficult to replicate in several of the African groups. The economic dominance of South Africa in any African group of which it is a member and of Nigeria in the Economic Community of West African States (ECOWAS), for example,

presents difficult challenges to effective cooperation given the other countries' fear that they could be swamped by the largest member of a group they join.

Lack of progress in previous initiatives has made many African policy makers somewhat skeptical about new ideas in this sphere. Doubts can best be overcome by selectivity and prioritization in considering new initiatives, placing the emphasis on efforts that both offer the prospect of sizable concrete gains and are politically and organizationally feasible.

Currency unions

Currency unions have been placed firmly on the political agenda. If we include the Common Monetary Area (CMA) arrangement linking the currencies of Lesotho, Namibia, South Africa, and Swaziland along with the two unions of the CFA zone, Africa has three working examples—the survivors of a more numerous set of colonial era relationships. This book is not the place for a full discussion of the common-currency issue. Despite political commitment to single-currency programs (undoubtedly inspired by the European Monetary Union project), most practitioners do not expect further single currencies to become a reality in any short time-scale—especially given the diversity of national macroeconomic policy conditions and the inability of most African governments to provide a fully credible commitment to a single currency.⁴⁴

Regulation and supervision

A regional approach seems to offer the most plausible scenario for gains in the area of intermediary regulation and supervision. Given the limited skill base that exists or can be afforded in these highly specialized areas, there must be significant potential benefits from pooling these skills for a multicountry region so that they can be deployed quickly in a crisis to where they are most needed. A multicountry approach also offers some additional political distance or independence. The experiences of the two regional banking commissions and the single regional insurance commission (covering all 13 states) in the CFA franc zone seem to bear this out, at least to some extent. The full potential is not realized even here, given the degree to which some powers related to licensing and sanctions remain at the national level. The Southern African Development Community (SADC) and the Common Market for Eastern and Southern Africa (COMESA) have also taken steps toward harmonizing banking regulation

and supervision, but these initiatives have not yet progressed very far. There is also the Eastern and Southern Africa Anti Money Laundering Group (ESAAMLG).

If a regional regulatory approach were extended to allow cross-border banking on the “single passport” principle adopted by the EU, it could enhance bank competition for small member states within the regulatory region. Banks could provide services across borders without incurring all the costs of separate incorporation in each jurisdiction. A single passport is in effect in both CFA zones, but it is not automatic either in theory or in practice. However, the barriers to entry do not seem to discriminate in practice between CFA and non-CFA applicants, thereby avoiding the danger that a regional approach could raise barriers to entry from solid international banks. SADC, in particular, needs to be alert to this danger, considering the importance of South African banks in many SADC countries already and the risk that they could form a lobby to resist the entry of international banks from outside SADC (Jansen and Vennes 2006). Similar arguments may apply even more to capital market regulation, especially since few African countries have or could have capital markets sufficiently large to fully justify the irreducible fixed cost of setting up a regulatory body that complies fully with international standards.

There is the countervailing danger that despite joining a regional association, members will forgo the potential cost savings by insisting on duplication of office facilities in each country (as seems to have happened, to a degree, in the CFA zone). Indeed, there can be diseconomies of regional cooperation also, if there is a multiplication of international representative meetings between the members. The opportunity for achieving operational and functional independence from national governments may also be missed, depending on the appointments and tenure procedures that are adopted.

A degree of harmonization of the legal framework for banking regulation would seem to be a prerequisite for a joint approach to banking supervision. It has also been suggested that such harmonization (for example, of minimum-percentage risk capital requirements) would be required to ensure a competitive, level playing field for foreign-owned and international banks, though this proposition is not so evident.

Securities markets

Recent technological advances have made it easier to link the operations of securities markets. It might be that by forming multicountry regional mar-

kets, existing exchanges could expand their volume of business and the number of market participants. The theoretical attractions are clear: larger markets are more likely to gain from the vertical and horizontal integration of services and products. Regional securities markets could provide larger economies of scale and increase firms' access to debt and equity. From an investor's perspective, regionalization would theoretically offer opportunities to diversify risk by allowing investment in a wider range of instruments and debt and equity issuers. The development of larger markets would encourage the entry of emerging market funds, which provide access to a global pool of savings for equity issuers. A variety of overlapping initiatives, all of which generally promote greater integration of stock exchanges in Africa, are under discussion (see Irving 2005; for East Africa, see Alawode and others 2002).

There is no doubt that cross-border cooperation and technology transfer can be helpful, especially if they help contain operating and regulatory costs. However, the inescapable fixed costs of establishing a simple, small trading platform are no longer very high. And cross-listing (rather than integration) can allow issuers to access a wider pool of investors. Therefore, the main operating advantage of integrating the functioning of securities markets is to improve liquidity on an hour-to-hour and day-to-day basis. But it is not clear how much would be gained in absolute terms even by pooling all the smaller African securities markets: the result would still be a small and illiquid market. Exchange controls operating between participating countries would eliminate most of the short-term liquidity advantage. (Also, bonds quoted in different national currencies might not attract much cross-border investment.)

Indeed, any proposals for regional securities exchanges must deal effectively with exchange control and other restrictions on cross-border investments in the securities. This point may seem obvious, but such restrictions are often imposed for policy and political reasons that will trump the objectives of securities market integration, and their resolution must be a prerequisite. If the time is not ripe for a general liberalization, limited forms of liberalization—allowing, for example, long-term investments by approved institutional investors—can be a viable halfway measure.

The success of the *Bourse Régionale des Valeurs Mobilières* in Abidjan has been modest. Cross-border investment using the market has been growing, but volumes are still small. Ivorian firms still dominate the equity board,⁴⁵ and it is not clear whether the overall operating costs (of the exchange and

its regulation and supervision) are lower than they would have been had Senegal, say, opted for a stand-alone exchange. In the other CFA zone (Communauté Economique et Monétaire de l'Afrique Centrale, or CEMAC), plans for a regional exchange have not received uniform acceptance.⁴⁶

More regionalization is likely to produce gains, but they would not all require an elaborate regionally adopted solution. Indeed, the technical, legal, and administrative efforts required for governments to establish and maintain a jointly controlled and fully integrated multilateral regional exchange (even if exchange control issues were overcome) suggest that less costly step-by-step solutions should have a higher priority. Each element of potential regionalization can be considered as a module. What is the best way to achieve regional economies of scale, liquidity, and risk pooling? Outsourcing to a common service provider for some services might be more effective than insisting on building a new, jointly owned multinational provider. For instance, back-office clearing and settlement services might be efficiently provided to a number of different exchanges by a single entity, even if those exchanges remained otherwise unlinked. Hammering out common regional software and technology standards might be unnecessary when satisfactory existing standards can be taken off the shelf.

Again, the use of linked trading platforms across several countries can be envisaged even if regulation and supervision remains national. A small country could exploit the existence of a well-functioning exchange in a larger neighbor, thereby bringing the advantages of better technology to the home market at lower cost.⁴⁷ This hub-and-spoke approach is much less demanding of political and administrative coordination than the multilateral approach, and it could be seen as a potentially promising path toward wider market integration. It can be designed in such a way as to prevent the danger of medium-size companies from poorer countries getting lost among the numerous listings on the larger exchanges. However, it does nothing to restrain the dominance of a small number of exchanges, which can seem unattractive for noneconomic reasons.

Cross-market listings in different countries are another, more limited, alternative to full regionalization. Such listings are already being tried, for example, with the cross-listing of Nairobi-based East African Breweries and Kenya Airways in Dar es Salaam and on the Uganda exchange. An available alternative for larger companies seeking a wider and more liquid market is simply to cross-list on a large international exchange, whether that of Johannesburg or elsewhere. Use of this option will certainly continue to grow.

It is instructive in this context to see the extent to which consolidation of the larger European securities markets is being driven more by private than by government initiative, through mergers and takeovers between existing firms that operate exchanges and related services. There is intergovernmental action in the EU to harmonize and coordinate regulation of these markets, but with exchange controls long since removed, government action has tended to follow rather than lead market integration in this sphere.

Legal framework and accounting

A common set of commercial laws is already in place in the CFA franc zone and could perhaps be achieved in the East African Community, where the member states share the English Common Law tradition. But a comprehensive unification of business law in a wider regional grouping that covers both countries with a Civil Code tradition and those with a Common Law tradition seems a rather remote prospect. Instead, legal harmonization efforts are better directed at more limited initiatives to draft certain framework laws to govern and help facilitate other cooperative arrangements in finance. In contrast, there seems more to be gained, at low risk and low cost, in seeking collaborative arrangements for accounting and auditing. There will be some efficiencies of shared learning and possibilities for cross-border auditing. And a region that has set up a common framework for adoption of the IFRS presents no barriers to further integration in the rest of the continent.

Supplementing the specific cooperative initiatives that may be adopted in these fields, a policy of “thinking regionally, but moving first to deliver the national prerequisites” is likely to be beneficial. This thinking is already embodied in the various macroeconomic and budgetary goals that have been set in African regional groups that aim to create or preserve a common currency and an economic union. It can also guide reforms in other areas (including payments) where cross-country collaborative projects are not yet active.

Notes

1. The Democratic Republic of Congo in the early 2000s is a good example here: civil war eroded monetization, and the banks placed much of their resources abroad. Equatorial Guinea is a good illustration of the limited absorptive capacity of a banking system in the face of large inflows—in this case of oil-related receipts.

2. The trend may in part reflect required reserves, though the monetary authorities' choice of required reserves can be influenced by the actual level of the bank's desired reserves, notably if the authorities wish to limit the emergence of sizable excess reserves. Anyway, while required reserves are high in several countries, a majority of African countries do have sizable excess reserves (IMF 2006).
3. If the survey had been confined to bankers, the responses might have been more critical. Furthermore, things are not so good when it comes to overdue payments, which are reported by 84 percent of African businesses—second only to South Asia. But this finding may be best interpreted as an indication of the informality of payment practices rather than of enforcement per se.
4. It also has the second-highest overall recovery cost, if this cost is expressed as a percentage of per capita income.
5. However, the correlation between credit registry coverage (numbers covered as a share of population) and creditor rights across countries in Africa is significantly positive at +0.61, essentially because large household-level credit registries are largely confined to South Africa and its small neighbors.
6. Azam, Biais, and Dia (2004) discuss the UEMOA banking crisis of the 1980s in terms of a model in which government interference could continue to influence the incentives of international bankers after a crisis.
7. Ironically, it was the ill-fated Meridien-BIAO that became the first private bank to be licensed in Tanzania, in 1991, after a quarter-century of state-monopoly banking.
8. Interestingly, in Kenya resolution of the events of the late 1990s involved large depositors taking considerable losses in some banks, as a result of conversion of part of their deposits to equity as a condition of the bank's survival.
9. Good accounts for the anglophone countries appear in Brownbridge and Harvey (1998). They describe, for instance, the Nigerian experience: liberalization after 1986 resulted in numerous entrants seeking the privileged access to rationed foreign exchange or the opportunity to indulge in looting and insider lending. Most of a previous wave of public sector banks (owned by provincial governments) were in distress by the early 1990s. The three biggest banks, each with a venerable history, survived better. They too had accumulated sizable nonperforming loans, perhaps 40 percent of their total lending, by the mid-1990s, but they stayed afloat thanks to their high liquidity and the overall lack of competitive pressure in the market, which allowed high margins on performing business. Another useful overview of African bank failures is contained in Daumont, Le Gall, and Leroux (2004).
10. One partial success story that illustrates the problems is the abortive first privatization attempt of the Uganda Commercial Bank to a company registered in Malaysia. That company proved to be a front for persons that were deemed unsuitable by the Ugandan authorities and who proceeded to self-lend on a large scale (Clarke, Cull, and Fuchs 2006).
11. Sometimes incentive can work in the opposite direction, with the strength of the local subsidiary flattered in the accounts for tax purposes.

12. An additional threat to be considered is the impact of HIV/AIDS, which adds costs and presents a variety of default and underwriting risks where the epidemic is severe. At the same time, financial intermediaries can be well placed to measure and manage these risks. See Kalavakonda (2005) and Magill (2003).
13. This is the name under which Standard Bank of South Africa (until 1987 a subsidiary of Standard Chartered Bank) operates in several other African countries. In 2000, Stanbic acquired the African operations of ANZ Grindlays, successor to the National Bank of India (but the main Kenya operations of the National Bank of India had become Kenya Commercial Bank).
14. The World Bank's Privatization database records 39 banking privatizations in Africa between 1988 and 2003, with total proceeds coming to US\$329 million. A further 50 nonbank financial sector privatizations—many in the insurance sector—for US\$100 million are recorded. See Senbet and Otchere (2006) for a critical view of the postprivatization profitability performance of African banks.
15. The tone of the letter received by the director of Barclays in Khartoum suggests a very polite takeover: "According to Revolutionary Council decision dated 25th May, 1970, Banks in the Sudan have been nationalized. Barclays Bank is now called State Bank for Foreign Trade. . . . You are therefore requested to report to your office at 10 a.m. tomorrow morning . . . in order to hand over your work. . . . Board of Directors of State Bank for Foreign Trade extend their thanks to the services you rendered in this country and wish you a pleasant future" (Ackrill and Hannah 2001).
16. In Tanzania, the operations of all seven existing private banks were merged into the new National Bank of Commerce.
17. In Nigeria, it is interesting to note that foreign banks were reluctant to accede to local incorporation. Barclays insisted on removal of the international brand when its shareholding in what became Union Bank of Nigeria was reduced to 20 percent as part of government policy. Contrast this reaction with the modern concern that fly-by-night foreign bankers will use their international brand name to build business, while limiting their exposure by hiding behind local incorporation.
18. Senegal's *Compagnie Bancaire de l'Afrique Occidentale* has assumed the 150-year heritage of the other colonial French bank, the BAO, whose travails in the 1990s are mentioned later.
19. The recent decision by the Dutch group Fortis to dispose of the Belgolaise network indicates that such concerns are not entirely unfounded.
20. For example, a ceiling of 49 percent was placed on the stake in Tanzania's NMB (National Microfinance Bank), which was acquired in 2005 by the consortium led by Rabobank and (prospectively) on Rabobank's share in Zambia's ZNCB (Zambia National Commercial Bank), though in both cases further share sales to nationals are planned.
21. Requiring accurate publication of charges is an exception. It can be a valuable consumer protection measure, albeit one that is only moderately effective in improving competition.

22. Entry, that is, of credible institutions with adequate capital and fit and proper management. The need for new entrants cannot absolve the regulators from due diligence. And there has to be some caution about embryonic proposals in the context of the World Trade Organization to have countries bind themselves to accepting entry of a bank licensed in any jurisdiction.
23. In the past those seeking to build stable banking systems sometimes advocated formal deposit insurance. However, cross-country research strongly suggests that unintended incentive side effects of formal schemes mean that their introduction is likely to be counterproductive in countries with weak overall governance institutions (Demirgüç-Kunt and Kane 2002). Only five such schemes are fully in operation in Africa today.
24. Only a few African countries (mainly Kenya, Malawi, and Zimbabwe) have made significant commitments binding themselves under the General Agreement on Trade in Services to permit market access in financial services. Given the risk that unsound entrants from poorly regulated foreign countries may take advantage of such commitments where host country supervisory capacity is weak, this caution is probably well founded. It is solid and well-managed banks whose entry should be encouraged.
25. The somewhat ambiguous term risk mitigation is sometimes used in this context where risk shifting would be more accurate. If credit guarantee schemes shift some of the risk to parties who are able to contribute to risk assessment or for whom the assumption of risk can act as a hedge in their portfolio, then there is a real gain. But if the motivation for the transaction is to benefit from a hidden subsidy or a flaw in prudential regulation, then risk is not being mitigated in the system as a whole and may in fact be amplified.
26. Although the guarantee company does some appraisal diligence on the loans guaranteed, this business may be partly a regulatory arbitrage.
27. Long-term lending at fixed interest cannot safely be funded by short-term deposits, given the repricing risk, a risk that can be very high in periods of macroeconomic volatility. This problem can be overstated, though, inasmuch as most borrowers will accept a floating interest rate as the price of getting security of funding for a term. Banks are increasingly aware of the need to ensure that this repricing is written into the contract and that the formula is a fair and transparent one.
28. Several such funds have been active in Africa including Actis (<http://www.act.is>) and Equator's Africa Growth Fund (<http://www.mbendi.co.za>). There may be some prospect in the future for deeper international engagement in risk sharing through such mechanisms as international credit derivatives.
29. Although the spinoff benefits for the poor of some FDI, especially some mining investment, can be questioned, there is no doubt that inward FDI already has and will increasingly have a positive effect on firm productivity and national economic growth. Analysis of microlevel data on firms shows sizable productivity gains from FDI into Africa (Moss, Ramachandran, and Shah 2004). At the macro level, FDI inflows, unlike capital market integration generally, are strongly associated with African growth (Collins 2004).

30. Even if no funds are raised and if the listed shares attract little or no trading.
31. One possible example: Tanzania Breweries, the largest firm on the Dar es Salaam stock exchange, with a market capitalization of close to US\$400 million and a dividend yield of more than 11 percent. Its principal shareholders, accounting for 94 percent of the total, are South African Breweries, 53 percent; East African Breweries, 20 percent; Unit Trust of Tanzania, 6 percent; Treasury Registrar, United Republic of Tanzania, 4 percent; International Finance Corporation, 4 percent; Public Service Pensions Fund, 3 percent; Umoja Fund, 2 percent; Parastatal Pensions Fund, 1 percent; and National Social Security Fund, 1 percent.
32. And, in any case, traditional nonelectronic callover trading methods, if efficiently organized—as in Dar es Salaam, for example—can be fully adequate for the volume of local trading and the small number of listings.
33. Second-board markets in advanced economies make different and, in some respects, lower demands on the issuer (lower, for example, in regard to having a track record of profitability, a minimum market capitalization, and a minimum number of shareholders; higher sometimes in regard to disclosure). Of course, the costs of going or staying public depend not only on regulations (in a narrow sense) but also on capital market architecture and industry efficiency. The experience of the AIM (Alternative Investment Market) in London (http://www.londonstockexchange.com/en-gb/products/companyservices/ourmarkets/aim_new) in seeking to minimize these costs for listing firms is instructive. The key is to adapt rules on corporate governance and disclosure in a pragmatic and appropriate manner and to remove regulations that are unenforceable in the local environment. For example, it might be useful to follow the AIM in placing the primary responsibility for much of the compliance with regulations on the “nominated adviser,” the financial intermediary bringing the firm to market (Grose and Friedman 2006). With governance issues largely devolved to the nominated adviser, AIM does not require (a) any minimum number of shares to be in public hands, (b) any trading record or minimum market capitalization, or (c) any prior shareholder approval for acquisitions (except reverse takeovers). Legal theory underlying the idea of adapting financial regulation to local conditions is discussed in Pistor and Xu (2002).
34. Considering that, by smaller companies, the U.S. committee means those with a market capitalization of less than US\$787 million, it is clear that these considerations are relevant for virtually all African enterprises.
35. Even minimal transparency requirements can frighten off potential listers. Moss (2003) suggests that this was one reason Ghana Telecom was not listed in the late 1990s after the sale of a strategic stake to Telekom Malaysia. Transparency to the market also implies transparency to others, including government. Moss also argues that owners of firms often have reason to be reluctant to make this commitment.
36. Akuffo (2006) provides an interesting account illustrating the difficulty of establishing mortgage finance on a scale commensurate with national housing

- needs. He describes the gradual mutation of an intermediary that was originally intended as the basis of a sustainable housing finance system in Ghana, with innovative product design, into a commercial bank initiating fewer than 100 mortgages a year and keeping just 30 percent of its assets in mortgage loans.
37. Africa's experience with private participation in infrastructure is well reviewed in Nellis (2005).
 38. PPPs in infrastructure trigger further financing alternatives. A well-designed PPP embodies the idea that each party should bear the risks that it is equipped to manage at least cost. For example, the private sector could bear construction, commercial, and financial risks, while the public sector bears political, regulatory, and legal risks. Demand risk is frequently shared because it is influenced both by regulatory policies and by market conditions. However, experience with PPPs in Africa has shown that the actual transfer of risks to the private party is often limited while private sector returns are high, suggesting a limited capacity of governments to negotiate such transactions effectively. If the benefit of a PPP is to exceed its cost (by comparison with public provision), attention needs to be paid in particular to avoiding large contingent liabilities through, for example, guarantees.
 39. Investor confidence could be strengthened by an enhanced approach to the planning of public investment spending, including (a) a rigorous and transparent approach to macroeconomic tradeoffs between social expenditure and capital investment in infrastructure; (b) systematic economic and financial cost-benefit analysis as a basis for project selection and prioritization for investment; (c) targeting of areas that cannot be financed by the private sector; (d) institutional structures and capacity to analyze, structure, and negotiate options for private participation; and (e) a transparent and fiscally prudent approach to potential government support in PPPs, such as direct subsidies or guarantees. In addition, further progress in regulatory reforms is required to reduce regulatory risk and move toward long-term financial sustainability of infrastructure sectors.
 40. There have been suggestions that, in order to boost market development, international financial institutions or other donors might (a) step in to provide complementary funding, such as project equity or subordinated debt finance, where private markets fail and (b) provide partial guarantees to the providers of infrastructure finance against, for example, regulatory risk. Once again, it requires a balancing act to ensure that such interventions actually support market development rather than create a dependency.
 41. Or they could help economies absorb sharply increasing revenues from natural resources, as has recently been occurring in Angola, Chad, the Republic of Congo, Equatorial Guinea, Mozambique, and Nigeria.
 42. Evidently this applies even to those external holdings that arise because of the need to hold cash collateral against import shipments.
 43. Other export credit insurance agencies have broadly similar ratings. The same agency's commercial risk index, running from 0 to 2, places the average African country at 1.83, compared with 1.18 for the rest of the world.

44. There have been numerous proposals for currency unions in Africa besides those currently in operation in the CFA franc zone (Fielding 2006) and in the CMA of southern Africa. Indeed, as far back as 1963, a common currency for the whole of Africa was an objective of the Organization of African Unity, and it remains a long-term goal of the African Union. Probably the most active current proposals are for the East African Community (EAC), which consists of Kenya, Tanzania, and Uganda, with the likely future membership of Burundi and Rwanda), which aims for monetary union as early as 2010, and the West African Monetary Zone (WAMZ), which consists of Gambia, Ghana, Guinea, Nigeria, and Sierra Leone, with the future planned membership of Liberia. The EAC aims for monetary union as early as 2010, and the WAMZ now aims for monetary union by December 2009. Later, there might be a merger of the UEMOA and WAMZ currencies to achieve the longstanding objective (since 1975) of an ECOWAS monetary union. Although the institutional arrangements for a monetary union could act as an agency of restraint (Stasavage 2000), this can be undermined by fiscal pressures and, as Masson and Pattillo (2005) have argued, divergent policy interests between prospective members could make joining costly for many. The potential gains in intraunion trade are not likely to be large. The EU experience has underlined just how much can be achieved in terms of financial integration without a monetary union, while showing that a single currency can contribute to financial efficiencies (Honohan and Lane 2001).
45. Although the Bank of Africa has joined Senegal's Sonatel as a non-Ivorian equity issuer, the bond market has a wider country representation. In addition to the West African Development Bank and the governments of Burkina Faso, Côte d'Ivoire, and Senegal, bonds are listed from state-owned utilities in Benin and Senegal and from other issuers from Burkina Faso, Côte d'Ivoire, and Mali.
46. The fact of a common currency gives the BRVM bond market a huge advantage relative to other regional projects covering multicurrency country groups. Only if the bonds are denominated in the same currency can there be any question of a common yield curve.
47. The electronic links between the Namibia and Johannesburg exchanges are an illustration. Indeed, the Johannesburg stock exchange has been encouraging a wider use of its technology—though so far others have been cautious about ceding leadership to Johannesburg.

Finance for All

Introduction: Access to Formal Financial Services

Fewer than 20 percent of African adults have an account with a formal or semiformal financial intermediary. However one may wish to measure it, finance for all is still a rather distant goal. This is as true for the savings and payment systems as it is for credit and lending. This chapter examines what steps need to be taken to increase this share—because it must increase if small and medium-scale enterprises (SMEs) and the poor are to benefit from modern financial technology.

An increased emphasis on the formal sector over the informal sector

To be sure, many more Africans have recourse to informal finance for both household and enterprise needs. It is not to diminish the importance of these networks to confine the present discussion to the formal financial sector. The existence of an extensive population of informal financial entities represents an important background for formal intermediaries. In particular, it should not be thought that microfinance institutions (MFIs) as we know them today provide a perfect substitute for the services generated by informal and traditional financial arrangements in much of Africa. However, as African economies modernize and grow, the formal financial sector will increase its relative and absolute importance in serving African households and firms (box 4.1). Access to formal financial services is an

BOX 4.1

Ignoring Informal Finance?

Africa enjoys a vibrant informal finance sector, ranging from shaky *susu* collectors in the marketplaces of Monrovia, to sizable rotating savings and credit schemes in Nairobi, which embody complex but effective incentive designs that have intrigued economic theorists, to *njangi* (ton-tines) in Yaoundé patronized by the upper-middle classes and processing sizable sums. The vigor of informal systems of intermediation in Africa is documented by numerous studies (Anderson and Baland 2002; Aryeetey and others 1997a, 1997b). When all types, formal and informal, are taken into consideration, perhaps 80 percent of the population has dealings with some form of financial intermediary, even if it is just a money collector or suitcase banker. In addition, as is the case worldwide, friends, relations, and business contacts provide important elements of financial support to SMEs.

Some scholars have assigned a deeper role to informal finance in African societies, discussing, for example, the distinctive role of ROSCAs in mediating interpersonal relationships—a function that has little resemblance to the performance of the formal financial system (Rowlands 1995). Udry (2000) provides some reflections on the wider role of social networks in understanding African economic activity.

That this book does not focus much on informal finance does not imply that it is unimportant or, indeed, that it will not survive the modernization process of which we speak. To be sure, the MFI revolution has, to a degree, built on the experience of these informal structures, and at the bottom end, some of the smallest licensed MFIs have little to distinguish them from informal arrangements.

At the smallest scale, formal and informal intermediaries will continue to function side by side for the foreseeable future—though the formal ones will tend to pull ahead. But the real effectiveness of formal finance lies in its ability to provide a wider range of services at a larger scale and offer a pooling of risks that cannot be attained by the informal sector.

area in which considerable progress can be envisaged in the years ahead. New technology, in terms of both financial engineering and information and communications technology (ICT), can be brought to bear on the problem. Some of the financial technologies discussed are not really new, even in Africa, but have not been applied as extensively as they could be.

Microfinance can service the financial needs of the poor—

The microfinance revolution has given MFIs the confidence to provide deposit and lending services to poor people. Different MFIs use different methodologies, and each claims special advantages for its techniques. Regardless, it is clear that, given the will and management skills, this sector can reach out to the low-income strata of the population in much of Africa—sometimes even without any subsidy, although the high interest rates that are often involved (even when far below moneylender rates) can limit borrowing to the most high-yielding uses of capital.¹ Here the challenge is to achieve scale and reach remote areas without losing management control of costs² and of loan appraisal quality.

—And also of SMEs

But this chapter addresses not only the needs of the very poor. With such huge swathes of the economy excluded in practice from access to financial services, attention needs to be paid to what may be described as the middle market. Small or even medium-size firms with credit needs of several thousand U.S. dollars may, given the state of many African economies, be on the margins of informality. They are not in a position to maintain proper business accounts. They are poorly catered to by banks, whose procedures presume a greater degree of formality. Farmers above the subsistence level are often in the same situation.

Good management is more important than organizational model

Who will deliver these enhanced services to these market segments? A proliferation of formal and semiformal intermediaries³—more than a thousand across Africa—is currently engaged in microfinance of one form or another. They vary enormously in scale, sophistication, and organizational design.

Advocates of mutuality sometimes argue that cooperatives should take the lead in delivering finance for all. This view has been implicit in the legislative framework in effect in the Union Economique et Monétaire Ouest

Africaine (UEMOA) countries of West Africa. Others argue that the economies of scale and scope of multiservice banks will ultimately give them an unbeatable cost advantage in catering to the majority. The fact that intermediaries representing a wide variety of organizational models have been successful in Africa argues against any dogmatic view either way on this point. At present, diversity and experimentation in organizational structure and business strategies seem to offer the best prospect for broader outreach. What are needed above all are improved management and cost control, as well as a greater awareness of the business opportunities by commercial financiers, who have hitherto neglected the “bottom of the pyramid.”

The broader financial policy environment also needs to be conducive to the expansion of microfinance. Ensuring sufficient competition to spur intermediaries into finding ways of safely serving a wider clientele—as well as ensuring that unnecessary regulations do not prevent such efforts—is a key requirement. Among the most important regulatory issues in this context are those relating to interest ceilings. Abuses of predatory lending are better tackled through policies of transparency and codes of practice with regard to lending procedures. South Africa has been a leader in the development and enforcement of such policies. At the same time, lenders cannot be complacent about costs that prevent them from reaching a wider market through lower interest rates. In addition, the higher the interest rates are, the greater the threat of a political backlash that would impose damagingly low ceilings.

In this chapter, all of the quartet of distinctive African environmental factors—scale, informality, governance, and shocks—are in evidence. Many of the microfinance innovations that have been seen worldwide and have been applied in Africa are specifically adapted to dealing with issues of scale and informality and also have application to certain governance issues. So far as shocks are concerned, though, microeconomic or idiosyncratic risk, rather than systemic risk, is most relevant for this chapter; paradoxically, microfinance may be more robust in the face of national systemic risk than in the face of local shocks.

In all cases, the key to ensuring access for smallholders and the poor is the use of innovative financial engineering and modern technology, combined with ruthless attention to low cost. Although some of this effort can be profitable, it is likely for the foreseeable future that at least some of the necessary energy and enthusiasm will have to come from public-spirited

activists whose job satisfaction comes from the social value of what they are achieving, rather than assurance that they are earning their opportunity wage in the global financial market. The modernist model alone will not be enough.

Technology and Financial Engineering

Many of the products conventionally offered by banks and even by MFIs in Africa are ill adapted to poor customers' needs. Sometimes the mismatch is painfully obvious, and the solution straightforward. Inflexible regular savings schedules are inappropriate for poor households with volatile cash flows. The same is true of overly flexible transactions accounts that allow costly overdrafts to be triggered inadvertently. Likewise, loan repayment schedules that do not take account of crop cycles are a poor match for smallholder farmers. Although many African intermediaries have developed a product mix that recognizes these problems, too many others have not. It must be stressed that, as much as one must look to novel solutions using the potential of innovative modern technology, long-established and proven financial technologies that can greatly improve financial access for poor people are often not yet in place in Africa. Correcting this situation will require training and outreach. By moving beyond what is generally established, modern technology offers some possibilities for leapfrogging some of the obstacles placed by slow-adjusting infrastructures and other African environmental challenges (Ivaturi 2006).

What kinds of innovations might work well for Africa? Evidently they need to be able to cope with some of the barriers that have been discussed; in addition, they need to have low unit costs. Innovations whose major cost relates to their initial development and other fixed costs, with very low marginal costs per transaction or per new customer engaged, offer important prospects for expanding access to financial services at the bottom of the pyramid.

Some examples already exist in Africa and elsewhere of the use of electronic or financial technologies to meet specific financial access problems. These examples show the potential and the limitations of solutions developed so far. They share some common features: the electronic accumulation, processing, and dissemination of information; the use of cell-phone and other telecommunications technology to bridge distance and isolation

problems; and risk pooling through the use of observable correlates for individual risk. Each of these features is associated with relatively low marginal unit costs; however, their setup costs are often considerable.

Credit Innovations

Although many practitioners have rightly reminded us of the importance of other dimensions of financial service access, policy discussions inevitably return to credit. Improvements in the credit environment can be expected from the range of meso-level policy innovations flagged in chapter 3. Improving the stock and usability of collateral is a clear priority. Some steps in this direction, including the improvement of laws governing leasing, hire-purchase, and factoring, can achieve much even without very effective judicial performance or wider governance improvements. Building effective title registries—adapted to local conditions and local concepts of user rights (Fleisig and de la Peña 2003)—helps the process of making collateralized borrowing available. Indeed, if borrowing is collateralized by exportable commodities or if the borrower has a subsupply contract from, say, a multinational mining corporation, credit can be easy to obtain in Africa. But what if neither believable numbers nor good collateral (direct or indirect) are present? What then can the would-be lender do to help appraise creditworthiness? What else is possible, other than to use collateral?

The first subsection here looks at four techniques that seek to do answer these questions.⁴ These are clearly part of the modernist agenda. The second subsection asks what is possible when reliance on an individual creditworthiness appraisal cannot be avoided, as is the case with much SME credit.

Techniques for reducing credit risk

In this subsection, we review four credit problems or financing gaps (ranging from agricultural inputs to construction of low-income housing) that have found solutions in parts of Africa. A key question here is whether the modernist agenda does it all: increasing reliance on automated credit approval systems based on verifiable information including accurate, inexpensive, and comprehensive credit registries; speedy enforcement of unbiased court judgments; and so forth. Or is there also a necessary and effective activist agenda that can help?

Experiences from African farm finance suggest that both dimensions may be necessary.⁵ Take the examples of contract farming and warehouse receipts finance. Both credit technologies are as old as finance itself, and both seek to resolve issues that are of considerable practical relevance. Expanding both has been high on many agencies' agendas for strengthening farm finance in Africa for several years (Kloeppinger-Todd 2005). Contract farming fits with the modernist agenda, with its credit aspects requiring no more than the basic legal infrastructures combined with private efforts. Indeed, specific legislation may not be required, as has been seen in Uganda. By contrast, warehouse receipts financing for small farmers does not get established without active specific intervention by a sponsor—though sometimes a private bank will find it advantageous to fill that role.

Credit associated with contract farming. In regions where export commodities are farmed on a smallholder basis, underuse of fertilizers is a well-known and longstanding problem to which solutions have been sought for generations. Cash credit for fertilizers (or other inputs) for smallholders is unavailable in eastern and central Africa. But wholesalers, exporters, and processors want to secure a reliable supply of the commodities to ensure that they can operate their facilities profitably. Over the years, in most African countries, private merchants have become the dominant suppliers of fertilizer on credit, as part of a contract farming arrangement, with the credit to be repaid out of the proceeds of the harvest (which are to be sold to the creditor).⁶ The benefit to the farmer is increased productivity; the potential downside is the possibly high cost of credit concealed in a low product price offered at harvest. The benefit of the arrangement for the merchant is the prospect of a good supply of product; the risk is that the smallholder might sell the crop on the side to another merchant and default on the loan.⁷

In practice, the arrangement often works well, when times are good. An International Fund for Agricultural Development study (Ruotsi 2003) found that, in the three countries studied, only the cotton supply chain in Mozambique exhibited evidence of market-power abuse by the lender. The lender had been granted a monopoly on cotton purchase in this case as a way of reducing the problem of side sales. One innovative way of limiting the risk of opportunist side sales is for the loan to be made to a cooperative of smallholders. Their collective interest in maintaining the

arrangement from year to year is likely more stable than that of any one of their members, and collectively they can exploit small-group dynamics to keep members in line—though this approach has not always worked out well in practice. But reflecting further on this supply-chain credit arrangement reveals that it is rather limited in terms of the range of financial services offered to the farmer, as noted by Pearce (2003). Besides, the amounts of credit are rather small. About half a million smallholders in Kenya use such an arrangement for tea, but the average loan is only about US\$30—a sum whose main value may be as a catalyst encouraging a more comprehensive shift to higher-value crops and methods of production.

Farmers seeking to take advantage of predictable seasonal price fluctuations. An alternative to the contract farming model has the farmer, or farmers' cooperative, financing inputs independently of the supply chain and selling the product directly onto the market. In this case, however, the farmer may be at the mercy of price fluctuations around the time of the harvest, unless credit is available to allow the timing of the sale to be optimized. Warehouse receipt finance—a technique that has been known for millennia but is still insufficiently used in Africa, despite numerous successful examples—can form the basis of a solution to this problem. By storing grain of verified quality in an approved independent warehouse, the farmer can offer considerably greater security to the lender.

But getting this kind of arrangement up and running for small farmers is not automatic. Because of scale issues, no group of small farmers will be able to do it on its own. Participation by large as well as small farmers will be essential to reach a viable scale. Then the warehouse operator also needs to establish creditworthiness—perhaps by being part of a warehouse network operating with peer review as a self-regulatory organization. The contract needs to be drawn up in a way that ensures that the banker really does have the semiautomatic security (grain is not released unless the loan is repaid; grain passes to ownership of the bank in case of delinquency) that the approach envisages. Experiences in Ghana and Zambia, for example, have shown how these issues—especially that of scale—have been decisive in making the difference between warehouse finance schemes that are viable and work well for small farmers and those that are not viable (Onumah 2003). Here, then, although the financial technology is very old, a degree of activism is still required by some sponsor who can generate the coordinated action that will be involved.

Two more examples, showing the effectiveness and the limitations of the modernist approach, come not from rural finance but from the cities: from the world of the salaried worker, a part of African society that is growing and will likely become much more important in the future, and from housing finance for low-income households. In one case, banks rely on the formality of their dealings with the employer to generate a surrogate for collateral; in the other case, a misguided modernist attempt to ensure housing quality backfired on what could have been a useful dimension to microcredit.

Salary loans. Low- and middle-income families with secure income often cannot capitalize their future earnings. Salary loans (another technique that has a long history but whose use has exploded in several African countries) can represent one limited but useful component of the solution to this problem. Technology is at work here too, in that electronic payroll administration makes this solution available and cost-effective for the credit provider. The bank—often one of the large international banks, which entered this market drawing on rapidly growing and profitable experience in South Africa—arranges for the loan to be repaid as a first claim on the salary check. These schemes are popular with employees and therefore with their employers. The loans can be put to multiple uses. They can help finance housing improvements and other consumer needs. In addition, it is said that they have also been used to provide seed capital for income-generating activities by other household members (with the primary borrower—the salaried member of the family—effectively acting as the guarantor of the actual beneficiary of the loan). In this way, at least some of the urban salary loans can find their way to funding small business income-generating investments even in rural areas, for example.

There are drawbacks. The bank has a quasi-monopoly position relative to the workers in each establishment. This situation may be contributing to what appear to be exceptionally high interest rates on such loans in some countries—perhaps resulting in supernormal profits, though this supposition awaits a thorough analysis. Regardless of whether the rates could be lower, the demand is high, and borrowers seem glad of the opportunity.

Progressive housing microloans. Classical mortgage finance is out of reach of the poor in most African countries. For one thing, they generally do not have formal title to the land on which they live. Also, they do not have the

regular income that a classic mortgage lender would like to see before extending a multiyear loan for a sum sufficient to build even a small house. But without credit, the poor may have to wait for several years of saving before they can make even modest improvements. Instead of reliance on a one-time loan, a progressive financing strategy is the preferred solution being explored by many microlenders wishing to use credit to improve housing for the poor. Progressive financing is, of course, how homes get built in the absence of any credit. The addition of credit allows a more substantial home to be built more quickly. Familiar characteristics of modern microcredit are employed. The first loan may be small and for a short term, but progressively larger and longer loans are made as the creditworthiness of the borrower is established more reliably. The main difference from a conventional microloan is that the term can go out to three or even four years. Break-even lending interest rates can also be lower, reflecting the fact that recovery of loan-processing costs is spread over the longer term.

As often is the case with microcredit, reliance is not placed on collateral; instead, such loans are typically offered only to those who have already established a credit history with the lender. Even if the borrower does not have formal title, as long as he or she has a de facto security of tenure the loan will not go to waste. As with housing finance at a higher level of income, success also hinges on a number of complementary actors, including local authorities, on whom the provision of basic infrastructure services such as water, electricity, and roads likely devolve. A 2002 study in Kenya found that building codes drawn up on the assumption that each housing unit would be built all in one go had the effect of making progressive construction illegal. Thus, a well-intentioned regulation, designed to protect the purchaser from incompetent or unscrupulous developers, had the unintended side effect of inhibiting improvements to the shelter of the poor, because it failed to recognize the impossibility for many to finance all-at-once construction (Brown and others 2002).

Relationship lending to small enterprises: How it can be done in Africa

The four examples in the previous subsection refer to techniques that, one way or another, economize on the need to make a costly customized creditworthiness assessment or to carry out borrower monitoring and follow-up (in several cases by tying the loan to an associated real transaction). An alternative approach—perhaps underused today by formal intermediaries in Africa in their dealings with the middle market—is relationship lending.

By limiting themselves to financing the large and collateralized borrowers, could banks be missing out on a lucrative market?⁸ Admittedly, the profitability in Africa of relationship banking with SME borrowers (as distinct from microlending) is uncertain. Hence, it may be that this type of lending should be seen as part of the activist agenda, likely to be sponsored by donors or in the public interest, rather than with a view solely to the financial bottom line.⁹

Observation of the conduct of intrafirm credit business in Africa throws light on some aspects of the environment that need to be taken into account if formal finance is to deepen its engagement with the middle market. After all, intrafirm credit represents a large share of firm financing. Thanks to a thorough analysis of a set of enterprise surveys in seven African countries (Biggs and Srivastava 1996; Bigsten and others 1999, 2003; Fafchamps 2004), we know quite a lot about this market (see appendix).¹⁰ Thus, lenders in the African middle market use a multidimensional evaluation of creditworthiness in making the loan or credit sale, looking at the borrower's capacity, business links, reputation, and character, and using soft or qualitative information where hard data are not available. This approach can be seen as not too far from the recommendations of banking textbooks, but gathering information is especially time consuming and costly and presupposes that the lender is embedded in the local economy. Intrafirm relationship lending in Africa also uses a flexible enforcement strategy, embodying the concept of the excusable default, with the borrower not being pursued for repayment unless and until he or she has the capacity to repay (Fafchamps 2004).^{11,12}

Can the modern African bank find better ways of acquiring more of this kind of information about their middle-market SME customers? Those that do can look forward not only to profitable lending, but also to having made a major contribution to the societies in which they operate. It is evident that the public authorities should be extra careful not to stifle such efforts by, for example, adopting regulations that insist on exaggerated levels of collateral or on preapproval of most clients by the central bank or banking regulator (as discussed in chapter 3).

Information, Insurance, and Risk Management Innovations

Although many types of financial product can help reduce or hedge risks,¹³ formal insurance schemes or other specific hedges go further than credit or savings, potentially spreading the cost not just over time but—by pooling

the risk—over many other agents, including those who are more able to bear it.¹⁴ Reducing the net effect of these risks can help increase average consumption over time as well as reduce its variance. But information problems of moral hazard and adverse selection, as well as administrative costs, hamper the viability of formal insurance products for poor households.¹⁵

The management of risk in rain-fed agriculture, on which a large majority of Africans depend in one way or another, has proved particularly challenging.¹⁶ Not only is it inherently risky, but the classic approaches of risk mitigation and insurance are both difficult to implement. Farmers use multiple approaches to risk management, including loss mitigation techniques (for example, intercropping, production mix, pest and disease control, water management) and reliance on savings. Agricultural insurance tends to be more effective in protecting farmers against infrequent and extreme losses, whereas loss mitigation techniques are more effective against frequent and small losses.

In addition to increasing farmer welfare directly, risk management instruments can facilitate access to agricultural credit at better terms as they increase the creditworthiness of farmers and other agents of the agricultural sector. To the extent that farm-level risk management instruments contribute to the overall financial stability of the agribusiness sector, indirect benefits in terms of credit availability may be realized at other levels of the agribusiness marketing chain. In principle, the first requirement for risk management is information: identifying, measuring, and tracking¹⁷ the risky conditions facing the insured person. This information is often hard to obtain: those who know it will not care to tell.

The overall experience of government-sponsored all-perils crop insurance has been financially disappointing almost everywhere, with claims and administrative costs constantly exceeding premiums. This situation reflects consistent underestimation of the catastrophic risks involved in agriculture, as well as uncontrolled moral hazard and adverse selection. Furthermore, it has not been popular with small farmers, with most of the uptake coming from (and subsidy going to) large farmers.

A new wave of initiatives being piloted in Africa using recent technological and conceptual innovations seeks to design insurance around risks that are important to farmers while remaining relatively easy to evaluate and verify and having limited moral hazard. Initial experience with weather insurance in Malawi is promising (box 4.2), though it remains to be seen just how effective such initiatives will prove when scaled up. A

pilot initiative promoted by CRDB Bank in Tanzania seeks to provide price-risk insurance to farmer and processor cooperatives (box 4.3). One lesson is that mainstream banks or other experienced intermediaries are needed to provide the link with global financial markets for reinsuring the tail or catastrophic end of the risks. From the users' point of view, a crucial—and sometimes decisive—deficiency of many such schemes is the scale of basis risk—for example, the lack of perfect correlation between the rainfall observed at the weather station and that experienced by the insured farmer (Binswanger and van den Brink 2005).

Deposit and Payments Innovations

Although somewhat overshadowed by a popular focus on microcredit, all who closely study the coping behaviors of poor people at first hand can see that the poor need simple and reliable savings and payments mechanisms before they need loans. Income receipts and spending needs do not generally coincide; household income that cannot be reliably saved at low cost may be dissipated; and the accumulation of sufficient funds to buy in bulk, or to buy durables or high-value items, largely depends on savings.¹⁸ Transmitting money to family members in remote parts of the country and receiving remittances from family members abroad are also key financial needs for most households.

The challenge for financial service providers is hardly related to credit-worthiness at all.¹⁹ Instead, the main challenge is to drive down unit transactions costs sufficiently. That is not easy in many parts of Africa, given the remoteness of bank offices and the tiny individual sums involved in the transactions of poor households.

Some mainstream financial intermediaries have not been interested in this market. The astronomically high minimum balances and high minimum transaction charges some banks insist on are clearly intended to discourage a mass market for which the bank finds no place in its business model.²⁰ But the use of innovative product design and modern technology has allowed other intermediaries to find ways of making this kind of business pay. As these innovators scale up, the larger players begin to reassess whether they could also share in the newly discovered profitability.

Several examples illustrate how financial innovations or communications technology can work in Africa to solve the problems of remoteness and small scale. The increasing demand for low-cost and convenient prod-

BOX 4.2

Pilot Weather-Based Insurance in Malawi

Most agriculture in Malawi is rain fed. Malawi also suffers from the cumulative effects of repeated droughts, land degradation, and—in some areas—flooding. Repeated droughts force rural households to deplete assets and engage in negative coping strategies; in addition, they create a continual state of food insecurity for the most vulnerable households. In addition to the ex post impacts of drought, the risk of a drought event also has significant impacts on the growth of the agricultural sector by slowing on-farm investment and participation in higher-risk, higher-return productive activities. Drought risk further stifles investment by farmers in higher-value crops because households cannot access credit to purchase such inputs as seed and fertilizer. Banks carry the same risks as their agricultural clients, so they hesitate to invest in agriculture because of potential default during a weather event or losses of revenue associated with low prices.

Traditional insurance has been tried on a small scale in Malawi in recent years, when a number of Malawian insurance companies introduced a multiperil crop insurance product. But after suffering considerable losses caused by moral hazard and high administrative costs in the first year of business, the insurance companies chose to get out of the business. After that experience, Malawian insurers were apprehensive about getting involved in offering agricultural insurance, but they were also interested to see how an alternative to the traditional multiperil policy would work.

The National Association of Small Farmers (NASFAM) is working with farmers to develop marketing channels for value added goods and encouraging its member farmers, who are organized into clubs of 15 to 20, to become more invested in higher-return activities. NASFAM has attributed the low productivity of Malawian farmers to a lack of both access to credit and quality inputs; in the first year, it chose groundnut as a pilot crop because of its resistance to drought and its growth potential in Malawi.

Groundnut farmers had little access to the credit needed to purchase groundnut seed and traditionally relied on local seed, if any, for production. Many NASFAM farmers had shown interest in planting with certified

groundnut seed in order to improve revenues. Certified seed, while more costly, has a number of benefits over local seed, such as a higher resistance to such diseases as fungal infections, which can destroy a crop. In addition, certified seed can be marketed as a named variety of groundnut seed rather than as a generic version.

The groundnut growing cycle has three distinct phases: establishment and vegetative growth, flowering and pod formation, and pod filling and maturity. Agronomic research data for each district, as well as farmers' experience, allow determination of the cumulative rainfall required in each growth phase to achieve a partial crop and avoid water stress. These rainfall trigger points have been made the basis of the insurance contract.

Because these weather contracts could mitigate the weather risk associated with lending to farmers, two banks, Opportunity International Bank of Malawi (OIBM) and Malawi Rural Finance Corporation (MRFC), agreed to lend farmers the money necessary to purchase certified seed if the farmers bought weather insurance. As of March 2006, 892 of NASFAM's farmers borrowed an average of about US\$40 each to pay for the seed, including about US\$3 each for insurance. The loan agreements stipulate that the bank will be the first beneficiary if there is a payout from the insurance. In addition, NASFAM, which will purchase the majority of the groundnut production from the participating farmers, has agreed to pay the first proceeds from the sale of the produce to the bank. If there is no drought, the farmers will benefit from selling the higher-value production. The participating farmers received information and training on the project jointly from NASFAM, OIBM, and MRFC, to make sure that they fully understood the costs and benefits before contracting for the product.

One issue that arose early during the pilot season was poor germination rates for the seeds. These rates were attributed to the poor quality and rotten seed purchased from the seed provider, not to deficit rainfall. This issue highlighted the fact that weather insurance is a limited protection against yield risk for banks. Once the problem was recognized, NASFAM worked with the seed provider to distribute additional seed to those farmers whose germination rates were low. Despite this issue, both lenders and the other participants in the pilot—farmers, NASFAM, the insurance association—were reportedly eager to scale up the program in future years.

BOX 4.3

Price Risk Insurance in Tanzania

Because marketing practices require them to set prices for farmers early on in the season, intermediaries such as cooperatives and processors in the coffee and cotton sectors of Tanzania are exposed to substantial price risk for six to eight months, during the time that these export commodities are being harvested, purchased, processed, and sold. Intermediary organizations that do not understand or manage this exposure have suffered large-scale trading losses, which resulted in their inability to meet debt obligations.

Local banks that lend to these organizations recognize that these financial exposures are very high. So far, the banks' response to this risk has been to manage it by charging high interest rates (12–14 percent) or curtailing lending when world market prices are moving in adverse directions (Bryla and others 2003). Recently, however, CRDB Bank in Tanzania initiated a new program to improve risk management for the bank and for borrowing clients by offering to intermediate hedging transactions using New York Board of Trade futures and options contracts. CRDB Bank has a strong incentive to actively implement improved risk management practices, because the bank understands well the risks that borrowers are carrying—sometimes better than the borrowers themselves. And unlike the cooperatives, a local bank can be an attractive client for the multinational banks and brokerage houses that offer hedging products. The local Tanzanian bank can then offer its borrowers customized risk management contracts that help manage the intraseasonal price exposure and reduce the risk of trading losses for cooperatives and ginneries. Ultimately, improved risk management practices at this level will improve the financial strength of the sector as a whole and reduce the risk of vulnerability to commodity price movements.

ucts proves that a client base exists for deposits and payments products. That demand has pushed providers to come up with innovative ways of reaching out to these untapped markets. They have combined technology and financial innovation to lower unit costs and to reach the poor in sparsely populated areas (Cracknell 2004; Global Development Research Center 2003; Truen and others 2005).

Mobile banking reinvented

For a variety of reasons, Kenya's Equity Bank receives deserved prominence among those interested in outreach to the poor. One reason is its practical reintroduction of a relatively simple technology brought up to date: the mobile banking unit. The bank is doubling its number of vans and expects to have 100 in operation by the end of 2006. Each van is equipped with laptops that have telecommunications links to a fixed branch, allowing the van to provide a wide range of banking services.²¹ One mobile unit visits each location once a week at a preset time. Already by mid-2003, two-thirds of loans outstanding were to clients served through mobile banking units (Wright 2005).

Equity Bank has also been creative in terms of providing savings products to respond to the needs of lower-income groups with small savings, as is reflected in its sizable excess of savings mobilized over loans extended (a relatively unusual feature among MFIs). Among its products is a contractual savings product called *jijenge*, designed to provide a disciplined savings mechanism that allows clients to save for predictable life events, with an emergency loan facility that allows the saver quick access to an emergency loan for up to 90 percent of the value of the amount in the savings account. The product design also gives the client the flexibility to set up a customized savings plan whereby he or she determines the length of the contract and the frequency of payments.

Smart cards

Teba Bank of South Africa has long been an innovator in saving and payments mechanisms, beginning with its handling of wage payments for migrant workers in the South African mines.²² Its Bank A-Card project is intended to use the existing cell-phone network to provide low-cost, entry-level, electronic banking services to low-income and underserved communities in poor and urban areas of South Africa. The user purchases a stored-value card, which can subsequently be topped up. The stored value can be used to pay for goods and services electronically. When a purchase is made, the amount is automatically deducted from the stored value and transferred to the merchant. The Bank A-Card has the functionality of a smart card and can be accepted at all point of sale (PoS) outlets that currently accept ordinary debit cards (DFID and FDCF 2004). This approach substitutes cellular technology for much more expensive fixed lines, using a simple, cost-effective wireless terminal that can be placed in shops fre-

mented by low-income clients. Simple magnetic-stripe debit cards allow for registration of accounts and purchases, cash-back functions, transfers to other accounts, recharges of call time, and third-party payments.

A more sophisticated use of smart cards is exemplified in the Remote Transaction System (RTS) being piloted by three microfinance institutions in Uganda. The RTS also uses a robust ICT solution to reach a greater percentage of the population in rural areas.²³ The RTS allows processing of loan payments, savings deposits, withdrawals, and transfers. At the front end, the technology solution comprises a PoS device equipped with a smart card reader, a printer for generating receipts, and cellular networking capabilities. Each client or client group uses a smart card and personal identification number to authenticate and authorize transactions. At the back end, the RTS includes a server that captures and retains all PoS transactions and connects to each participating MFI's management information system and the accounting systems of all participating institutions (Kam and Tran 2005).

Following this pilot, the MFIs have been rethinking their business processes in order to exploit the full potential of the RTS. Without such a rethink, overlaying the new technology might merely add cost and complexity. The technology has challenged the limits of local physical infrastructure (erratic telephone connectivity, unreliable electricity sources) and the literacy of customers. Furthermore, the pilot showed that the cost associated with building the infrastructure to support this enabling technology would have been too high for the MFIs to incur on their own and that only through shared infrastructures and common standards can the costs of providing financial assistance to a dramatically larger client base be realized (Firpo 2005). However, the fixed costs having been incurred, the consortium has released RTS as a solution available to developers without a license fee. Here again, we see the logic of both the modernist agenda—using the most advanced technologies available—and the activist agenda, pro bono innovators incurring a fixed cost that can lead to benefits for other smaller MFIs with limited resources and for their customers.

Cell-phone banking

A growing number of African countries enjoy cell-phone banking, which has considerable potential outreach given the rapid expansion of cell-phone use—although it still may not reach the poorest. The value of cell-

phone banking appears highest where the physical presence of well-functioning banking institutions is weakest—as, for example, in the Democratic Republic of Congo. The payments system introduced by Celpay there and in Zambia illustrates how such systems work.²⁴ The product allows a subscriber to use a cell phone to pay bills, an important innovation in a country where few people have credit or debit cards and carrying cash can be dangerous. To make a payment, the subscriber sends a text message with the details to Celpay, which then returns a text message to the subscriber's cell phone asking for a personal identification number (PIN) to confirm the transaction. Once that is done, Celpay transfers the money between the participants' bank accounts.

The system already has 2,000 users in Zambia, each making several transactions per month. The recipient typically pays Celpay between 1 and 2 percent of the value of the transaction in commission. PIN verification ensures that the system is secure and that both payer and payee receive confirmation of the transaction with a unique reference number; full details of all transactions are available online. The product is simple to use for anyone who knows how to send an SMS (short message service) text message. A registered Celpay user must deposit money into a Celpay account; spending by cell phone can then commence. The user's remaining balance can also be checked by cell phone (Wood and de Cleene 2004).

Lessons from the innovations

These examples illustrate the potential of mobile phones, satellite phones, portable computers, and smart cards in overcoming remoteness and processing-cost barriers to providing payments and making deposits (and sometimes other financial services). They also illustrate a more client-oriented approach to savings product design. If the financial intermediary is focused on reaching the poor, it can easily overcome other barriers—such as the reluctance of poor people to approach an intermediary for fear of being treated with disrespect.

But experience has also shown the sizable setup costs. Piloting was important in nearly all these cases in order to refine the model before rolling it out to a wider clientele. The pilot phase involved interviews with the clients and helped the providers understand clients' needs and preferences. Their views were reflected as much as possible in the product redesign, even though it generally entailed additional investments

and training of staff to adapt the intermediaries' working methods. The up-front costs of these innovations and the risk that the scale of uptake will be too low are among the barriers that have slowed progress here. Though all these schemes have the air of modernity about them, they also require a degree of activism by the pioneers in attempting the initial innovations—which may not have been remunerated quickly in many cases.

A long-neglected area: International remittances

Despite considerable recent interest in international remittances generally and efforts to define best practices (Isern, Deshpande, and van Doorn 2005; CPSS and World Bank 2006), the study of international remittances to Africa remains in its infancy (Pearce and Seymour 2005; Sander and Maimbo 2003, 2004). The identified flow of remittances into Africa (through formal channels) jumped from US\$1.2 billion in 1994 to US\$4.3 billion in 2004 and may have reached US\$8 billion in 2005. Three countries—Nigeria, Sudan, and Uganda—account for three-fourths of these measured flows (and the top 17 countries—including all with US\$10 million or more—account for more than 97 percent). Even this sizable sum is thought to greatly underestimate total flows—perhaps by about half.²⁵ As shown in table 4.1, several sizable countries regularly receive inflows in excess of 5 percent of their GDP.²⁶

Data are especially lacking on remittances between developing countries, which are relatively more prevalent in Africa than elsewhere: a sizable data collection effort is needed here (World Bank 2005). Indeed, the dynamic and complex patterns of migration in Africa, which create the need for remittances, are themselves not well understood. There has been a feminization of migration, a diversification of migration destinations, a transformation of labor flows into commercial migration, and brain drain from the region. Completing this picture are trafficking in human beings, the changing map of refugee flows, and the increasing role of regional economic organizations in fostering free flows of labor (for a detailed discussion, see Adepoju 2004). Untangling the policy implications for remittance flows of these multifaceted migration characteristics is methodologically challenging.

While the prominence of remittances on the continent continues to grow, the outreach and quality of the financial sector infrastructure for remittances largely remain weak. Compared with some of the technologi-

TABLE 4.1
Remittances: Top Sub-Saharan Recipients

Recipient country	US\$ million	Percentage of GDP ^a	Year of last observation
Lesotho	223.0	29.2	2004
Cape Verde	92.1	15.2	2003
Guinea-Bissau	21.3	6.8	2003
Uganda	306.1	5.8	2004
Sudan	1,401.2	5.7	2004
Senegal	448.2	5.4	2003
Togo	128.3	3.9	2003
Mali	138.9	3.5	2003
Benin	49.5	3.2	2003
Nigeria	2,272.7	2.6	2004
Burkina Faso	43.6	1.9	2001
São Tomé and Príncipe	0.6	1.2	2002
Sierra Leone	24.6	0.9	2004
Ghana	82.3	0.8	2004
Mozambique	2.5	0.6	2004
Ethiopia	133.4	0.5	2004
Niger	11.5	0.5	2003

Sources: World Bank's World Development Indicators database, except for Lesotho, data from the United Nations Conference on Trade and Development database Handbook of Statistics 2005.

a. Average 2000–02 flows as percentage of 2001 GDP.

cal solutions discussed above, remittances appear a poor relation but one that could be transformed. The cost of remittances between industrial and developing countries appears to be higher to Africa than to other regions (Hernández-Coss, Egwuagu, and Josefsson 2006). To date, most formal remittances use long-established, speedy, and reliable—but still rather costly—services by money transfer operators (MTOs)²⁷ such as Western Union and its competitors.²⁸

For too long, financial and monetary policies and regulations have created barriers to the flow of remittances and their effective investment (box 4.4). Foreign exchange controls, bureaucratic account opening and cash withdrawal procedures, and limited rural branch networks contribute to an ongoing preference for informal methods of transferring funds. Wide gaps between official and parallel market exchange rates have also encouraged the use of informal channels, as have other explicit or implicit taxes. And for migrants forced to migrate illegally, informal methods are often the only option.

BOX 4.4

Improving the Remittances Situation

Overall, Africa's formal remittance infrastructure's potential is not being maximized. The region remains largely cash dominated. In particular, the proportion of the rural poor who have access to formal banking services, let alone formal payments systems, remains very low. An improved remittance infrastructure on the continent would make advances in five areas (CPSS and the World Bank 2006):

- Transparency and consumer protection
- Payment system infrastructure
- Legal and regulatory framework
- Market structure and competition
- Governance and risk management practices

The market for remittance services should be transparent and have adequate consumer protection. Recently, the UK Department for International Development and the Banking Code Standards Board commissioned a survey on money transfer products offered to members of the diaspora in the United Kingdom in order to address this lack of information and transparency. A number of primary UK remittance destinations were chosen for the survey, including Ghana, Kenya, and Nigeria. Better information on money transfer services should not only help remitters choose a service that best meets their needs, but also promote healthy competition between money transfer providers—competition that reduces the cost and improves the service for remittance senders (Isern, Deshpande, and van Door 2005; Pearce and Seymour 2005).

Improvements to payment system infrastructure that have the potential to increase the efficiency of remittance services should be encouraged. The choice of remittance method is determined by several factors, including ease (methods with less paperwork and documentation requirements were preferred); familiarity (often the remittance method used is the method used by parents and grandparents or recommended by friends and family); cost (although participants had little precise knowledge of cost

structures, their perceptions of which methods were cheapest tended to be accurate); speed (of particular importance when the remittance is intended to meet an emergency need); risk tolerance (for theft or other losses; participants claimed to become more risk averse as the size of the remittance increased); and access (how easy it is for the recipient to reach the delivery point). In South Africa, for example, sending by means of a taxi driver is cheap, there are no forms to fill in, and the unbanked can access this means easily. The method is used extensively for both domestic and cross-border remittances and with equal likelihood by both blue- and white-collar workers. Participants also believed that the post office had a much better rural distribution network than the banks and was comparable to the bank in terms of safety and speed (Truen and others 2005).

Remittance services should be supported by a sound, predictable, nondiscriminatory, and proportionate legal and regulatory framework in relevant jurisdictions. Current licensing regulations for money transfer services center on foreign exchange trading. For smaller money transfer operators and informal services, regulations often are opaque and hard to access; compliance may be unaffordable. To be in a better position to review and enhance the regulatory frameworks used in Africa, we must improve our understanding not only of African remittance markets, but also of the business models that make nonbank transfer services attractive to client segments elsewhere in the world and of how those models are licensed and regulated. A facilitative framework in which licensing requirements were adjusted to reflect actual needs for transparency and for management of foreign exchange exposure could greatly enhance the availability and outreach of basic financial services, including money transfers.

Competitive market conditions, including appropriate access to domestic payments infrastructures, should be fostered in the remittance industry. For example, in the absence of a functioning banking system, money transfer companies in Somalia have had an impressive history since the fall of the government in 1991. The market functions very efficiently, providing quick and inexpensive services to all parts of Somalia. The remittance flows through these companies provide subsistence and essential services for families in Somalia. They also facilitate international trade and domestic commerce, even in the remote parts of the country, and finance domestic investment in businesses, community services, construction, and real estate. The principal challenge for government, once it is fully established, will

(Box continues on the following page.)

BOX 4.4 (*continued*)

be to find a way to take full advantage of the dynamics of this part of the financial system for the benefit of the Somali private sector while combating the reputational risks of an unregulated industry.

Remittance services should be supported by appropriate governance and risk management practices. As is the case for the payments industry generally, the international remittance industry faces legal, financial, operational, fraud, and reputational risks. In establishing risk control measures, remittance service providers should conduct risk-level assessments to ensure that proposed risk control measures are appropriate to the level of the risks and the size of the business generally. Therefore, money transfer operations need significant investment in skilled human capital (Isern, Deshpande, and van Doorn 2005). New operators need to train staff or hire specialized staff for customer relations and back-office functions. Information systems must be capable of managing the volume of anticipated transfers, ensuring transaction security, possibly interfacing with other transfer operators, and generating reports to comply with regulations (such as anti-money-laundering legislation).

Organization: Who Needs to Do What?

From the examples provided, it is evident that some of the technology-driven innovations that can help improve financial access in Africa can be and are being spontaneously implemented by market intermediaries in some countries. It is likely that more will come from private initiative in the future (not least through the rollout of what has worked in one country, including through the activities of banks, MFIs, and others that are active in more than one country). However, given the fragmentation of national African markets and the small scale of the individual transaction or relationship, the prospective rate of return on the necessary fixed-cost investments in financial technology can seem too low to the private entrepreneur—especially in the generally adverse climate for private investment in Africa, as discussed in chapter 1. Furthermore, several of them have collective action issues (the investment not being worth making unless several intermediaries do it at the same time). The following discussion addresses the question of how this logjam can be broken, whether

by donors; by governments at local, national, or transnational levels; by individual banks or associations of private financiers; or by associations of users (as, for example, with mutual credit insurance).

A major theme running through this discussion is the need for adequate governance, in particular where the activist agenda is in play. Activists are not restrained by immediate market pressures; they have chosen to plow money and effort into endeavors that the market has declined. To be even reasonably confident that these efforts and resources will not be wasted or subverted, the sponsoring agency must have good governance. It could be a private entity with deep pockets, likely combined with a social conscience; it could be charitable or donor agencies. National or local governments are not, in present conditions, the most suitable candidates to sponsor an activist agenda in the financial sector.

Diversity of Organizational Models in African Microfinance

One of the most striking features of the recent and ongoing expansion of the microfinance movement in Africa is the proliferation of different types, in terms of financial technology applied, organizational structure, degree of formality and regulation, and clientele. The diversity seems wider than in other regions. Not only that, but the relative importance of different models—even of formal microfinance—differs widely from country to country.

As Robinson (2006, 15–16), reviewing available evidence for Africa, puts it:

Regardless of their history or institutional form, however, large-scale financially self-sufficient institutions with responsible ownership, skilled governance and management, knowledge of the market, and commitment to microfinance best practices—and a corporate culture emphasizing training, incentives, transparency, efficiency, and accountability—are found clustered at one end of this continuum. The majority of microfinance clients are also clustered at this end. At the other end are the many microfinance providers that lack most or all of these crucial elements. The middle ground is home to numerous positive efforts and to multiple obstacles.

Quantifying the relative importance in outreach of different sizes and types of provider is an inexact science. For one thing, the number of

providers is very large. As far as the formal and semiformal sectors are concerned, the most comprehensive database is that prepared by the Consultative Group to Assist the Poor (CGAP) (Christen, Rosenberg, and Jayadeva 2004),²⁹ which has more than 800 African entries, even though networks of cooperatives and credit unions are assigned only one entry each (as is the Nigerian community bank system). However, the 44 largest entities (by number of accounts) account for about 80 percent of the client base across Africa, fully justifying Robinson's statement that the "microfinance industry in Africa is becoming dominated by large, mature financial institutions and federations with wide outreach" (Robinson 2006, 16). Each of these entities caters for at least 100,000 clients (table 4.2). As with the full list, the top 44 include a wide range of different types of entities: state-owned banks, including postal savings banks; privately owned banks; cooperative savings and credit institutions; and nongovernmental organizations (NGOs).

TABLE 4.2

Large Financial Intermediaries and Networks in Africa Ranked by Outreach

Country	Name of institution	Type	Number of accounts
South Africa	Post Bank	Postal bank	2,100,000
Zimbabwe	People's Own Savings Bank	Savings bank	1,695,000
Kenya	Kenya Post Office Savings Bank (KPOSB)	Postal bank	1,636,000
Ghana	Rural and Community Banks	Banks	1,200,000
Niger	Caisse Nationale d'Épargne	Postal bank	1,124,000
Nigeria	Community Banks	Unit banks	1,000,000
Tanzania	Tanzania Postal Bank	Postal bank	954,000
Kenya	Kenya Union of Savings & Credit Co-operatives (KUSCCO)	Credit union or cooperative	952,000
Côte d'Ivoire	Caisse d'Épargne et des Cheques Postaux (CECP)	Postal bank	828,000
Cameroon	Caisse d'Épargne Postale	Postal bank	700,000
Tanzania	National Microfinance Bank	Bank	670,000
South Africa	Teba Bank	Bank	649,000
Madagascar	Caisse d'Épargne	Postal bank	574,000
Rwanda	Banques Populaires	Credit union or cooperative	385,000
Benin	Fédération des Caisses d'Épargne et de Crédit Agricole Mutuel (FECECAM)	Credit union or cooperative	378,000
Burkina Faso	Caisse Nationale d'Épargne	Postal bank	363,000
Benin	Caisse Nationale d'Épargne	Postal bank	350,000
Côte d'Ivoire	Fédération Nationale des Coopératives d'Épargne et de Crédit de Côte d'Ivoire (FENACOOPEC-CI)	Credit union or cooperative	291,000

TABLE 4.2 (continued)

Country	Name of institution	Type	Number of accounts
Botswana	Savings Bank	Postal bank	287,000
Nigeria	Countrywomen's Association (COWAN)	NGO	270,000
Uganda	Centenary Rural Development Bank	Bank	251,000
Burkina Faso	Fédération des Caisses Populaires	Credit union or cooperative	248,000
Mauritius	Postal Savings Bank	Postal bank	245,000
Sudan	Savings & Social Development Bank	Savings bank	230,000
Ethiopia	Dedebit Credit and Savings Institution	Nonbank financial intermediary	221,000
Ethiopia	Amhara Credit and Savings Institution	Nonbank financial intermediary	216,000
Namibia	Postal Savings Bank	Postal bank	209,000
Senegal	Caisse Nationale de Crédit Agricole	Agricultural bank	205,000
Malawi	Savings Bank	Postal bank	204,000
Cape Verde	Caixa Económica de Cabo Verde	Savings bank	200,000
Togo	Caisse d'Épargne du Togo	Postal bank	200,000
Senegal	Caisse Nationale d'Épargne	Postal bank	197,000
Gabon	Caisse Nationale d'Épargne	Postal bank	175,000
Kenya	Equity Bank	Bank	173,000
Malawi	Malawi Rural Finance Company	Nonbank financial intermediary	166,000
Niger	Mata Masu Dubara CARE	NGO	162,000
Nigeria	FADU (Farmers' Development Union)	Nonbank financial intermediary	156,000
Ethiopia	Credit Unions	Credit union or cooperative	150,000
Cameroon	Cameroon Cooperative Credit Union League (CAMCCUL)	Credit union or cooperative	149,000
Tanzania	Savings and Credit Cooperatives	Credit union or cooperative	137,000
Togo	Faîtière des Unités Coop (FUCEC)	Credit union or cooperative	133,000
Sudan	Agricultural Bank of Sudan	Agricultural bank	125,000
Uganda	Postbank Uganda	Postal bank	122,000
Mali	Kafo Jiginew	Credit union or cooperative	115,000

Source: Revised by the authors using data from Peachey and Roe 2005 and Christen, Rosenberg, and Jayadeva 2004.

Note: The table includes intermediaries or networks with an outreach objective and with more than 100,000 accounts or customers. It overstates access to the extent that some accounts are dormant: the proportion of dormant accounts in post offices is often very high. The Ghana Association of Rural Banks network is still a fairly loose organization. The Nigeria community banks are not grouped into any formal network.

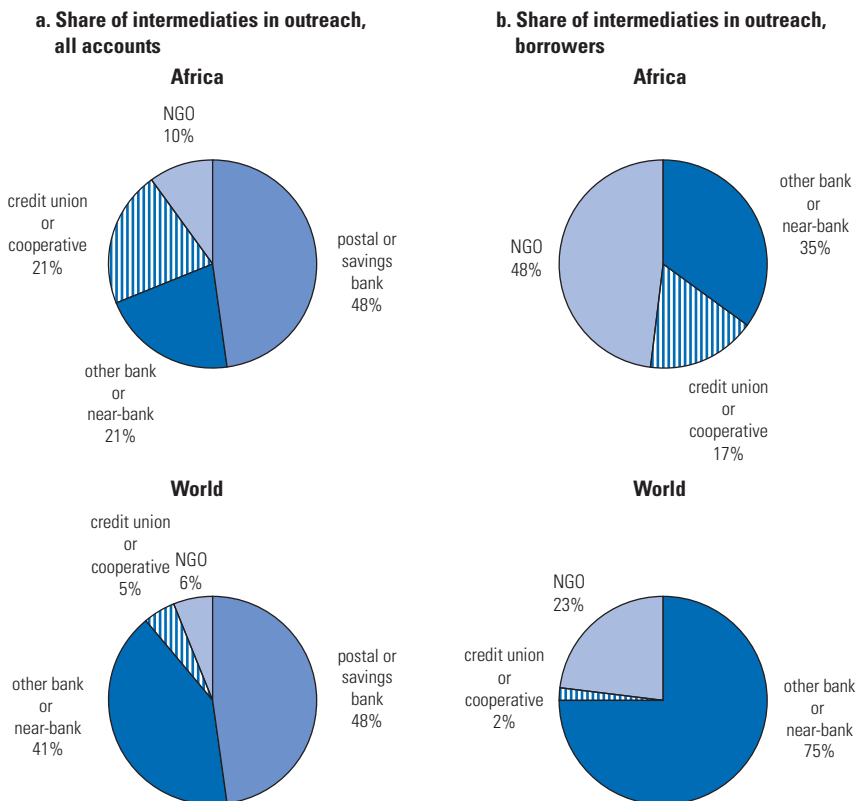
In interpreting table 4.2, one must recognize that the number of accounts is a most imperfect measure of outreach.³⁰ Many accounts, especially it seems at postal savings banks, are dormant and thus contribute little to welfare. (As few as 10 percent of the accounts at Uganda's postal savings bank are thought to be active.) Then again, the range of services available from different types of intermediaries differs widely.

These points need to be borne in mind when observing that overall almost half the accounts recorded in the CGAP database for Africa (as aug-

mented) are at savings or postal banks. This figure is about the same as reported for the developing world as a whole. But the breakdown of the other half is quite different in Africa, where various forms of credit cooperatives and NGOs both account for a much higher percentage (20 percent and 10 percent, respectively) than is found in the rest of the world (figure 4.1). However, these shares vary sharply across Africa. In 11 of the 42 African countries in the database, savings and postal banks report more than three-fourths of the accounts; nonbank MFIs have more than three-fourths of the accounts in 16 countries. This finding displays the contrasting mix of organization forms that are observed in African countries.³¹

FIGURE 4.1

Share of Cooperatives, NGOs, Savings, and Other Banks in Providing Access



Source: Revised by the authors using data from Peachey and Roe 2005 and Christen, Rosenberg, and Jayadeva 2004.

Looking at loan accounts, one notes that here, too, the relative importance of cooperatives and NGOs is much higher in Africa (figure 4.1). This finding raises two questions: Is there something special about the mutual model in Africa? Could banks play a bigger role?³²

Different Forms of Mutuality

Elements of mutuality³³ contribute strongly to an effective credit culture and to information flows that strengthen credit appraisal and credit discipline. These processes are arguably stronger for relatively small groups and hence, in practice, for small-scale intermediation. They are especially advantageous in informal environments and where external enforcement of credit contracts cannot be ensured. Their strengths thus seem particularly well adapted to environments that are widely experienced in Africa.

Mutuality in African microfinance is observed both in lending and in governance of the intermediary. These are not closely correlated. Whereas some commercial banks and donor-controlled MFIs sometimes use group lending techniques, many cooperative or mutual savings and credit institutions in Africa rely on individual loans but collective governance.

Variations in group lending have been found effective in different environments and in relation to different types of clients. Increasingly, the leading microlenders no longer confine themselves to a single lending model. As just one example, the international NGO CARE promotes an eclectic mix of techniques. For urban and periurban areas, small groups of four to six people are formed.³⁴ Larger “village” groups of 20 or more are used in rural areas.³⁵ Another model used by CARE for low-capacity groups, usually women, in remote areas is designed to stimulate and educate these groups to achieve self-organization, with a savings and credit association depending entirely on accumulating the group’s own savings (Allen 2002). MFIs across Africa practice many variants of these techniques, differing in contract design as well as in group size.³⁶

At the other end of the spectrum, other MFIs favor individual-based loans, seeing them as more flexible and responsive to each borrower’s evolving needs than group lending, which can proceed only at the pace of the slowest developer. Procredit/IPC exemplifies this approach. The fact that it has secured banking licenses in several countries illustrates how close its model is to traditional banking—even though with a focus on smaller and lower-income borrowers and therefore with the need to

emphasize cost control. Many mutually owned MFIs also make individual-responsibility loans—indeed, this is the classic credit union model.

The distinction being made here is not hard and fast. For instance, in a credit union, individual borrowers are linked through their participation in the ownership of the cooperative, albeit in a much weaker way than can be implied by participation in a group or cross-guaranteed loan. Mutual guarantee associations blur the distinction even more.

Group or individual lending?

Which model is best? For lending, there is little evidence to suggest that either group or individual lending clearly dominates (Cull and Giné 2004).³⁷ For instance, reliance by group lenders on peer pressure may not always work. In agriculture, the group may be faced with a common or at least covariant risk. Some borrowing farmer groups have colluded to misrepresent their ability to repay—see Binswanger and van den Brink (2005), whose proposal for a sophisticated and coherent community-based structure for coping with the complex risks and incentive problems faced in rural finance deserves more attention than it has yet received.

Perhaps the persistence of a multiplicity of models means that different models work best in different environments. But such a Panglossian conclusion may not be warranted. Survival of the fittest is unlikely to prevail quickly in the social lending sector, which is often donor aided and in which institutions generally have a management team motivated by social concerns. Persons with the multidimensional management skills required to fill a top position in an MFI typically have the qualifications to secure a very highly paid job in the financial service industry in an advanced economy. They stay in African microfinance because of their social motivation. This complicates the comparative evaluation of MFI models, because even an inferior model can be made to work and to survive against the odds if supported by the efforts of able and highly motivated managers. Furthermore, while a growing number of MFIs are reporting profits, others are still kept afloat in practice by donor funds (sometimes in the form of cheap loans and equity, rather than grants). Although donors will not back a losing model indefinitely (and some exits unprofitable MFIs have already exited), their behavior can prolong its life.

The success of cooperatives: Mirage or miracle?

A common misconception among nonspecialists is to suppose that mutuals systematically cater to poorer clients and make smaller loans. The aver-

age loan size for the cooperatives in the sample of African MFIs studied by Lafourcade and others (2005) was about US\$500, or about 120 percent of national gross national income (GNI) per capita, well above the average of US\$300 for the sample as a whole.³⁸ Even though this finding suggests that cooperatives cater to a less poor clientele on average, cooperatives report a lower return on assets at 0.4 percent, compared with more than 2 percent for the rest. Social or statutory ceilings on lending interest rates likely contribute: unregulated MFIs have much higher unit costs but more than recover those costs on financial revenue.³⁹

Bearing in mind that formal savings and credit cooperatives are, in Stuart Rutherford's (1999) colorful phrase, supercharged rotating savings and credit associations (ROSCAs), it would nonetheless likely be a mistake to assume that the cooperative form is particularly focused on higher-income groups. If data on informal ROSCAs were included, the average loan size for this wider definition of cooperatives would be much lower.

Despite reliance on mutualist ideas of solidarity and social capital, the cooperative model is not immune to failure resulting from malfeasance or insouciance. One problem can be the difficulty of coping with external funding, compromising the self-reliance on which cooperatives are supposedly built. The failure in 1998 of the largest network of cooperatives in Benin, FECECAM (Fédération des Caisses d'Épargne et de Crédit Agricole Mutuel), illustrates this. In that case, among the many lessons learned was "the realization by the network that rapid growth under the impulse of lines of credit at the expense of good financial management can jeopardize an institution's sustainability" (Ouattara 2003, 11–12). Endemic management and portfolio weaknesses have been noted also in East Africa, where the savings and credit cooperative (SACCO) mutualist model may be losing out to other institutional forms.

Furthermore, the mutualist glue that holds the model together in good times may dissolve suddenly if there are adverse shocks, with members deciding not to repay if the institution is seen as likely to be unable to make future loans. The recent case of mutual guarantee associations (MGAs) in Madagascar is a case in point.⁴⁰ The MGAs had been developed at the instigation of the national ministry of agriculture, livestock, and fisheries as a way of facilitating the extension of agricultural credit from the multinational Bank of Africa in parts of Madagascar where no mutualist credit institutions were active. However, the crisis of 2002 brought a collapse in farm-gate prices and an inability by some to make repayments,

which escalated into a general collapse of credit discipline, with even the organizing committee members of MGAs refusing to repay (Bennett and others 2005). Once again, postmortems identified a failure to embed the solidaristic principles that are presupposed by the mutualist model: for example, the overstrong role of the ministry in promoting the scheme and the lack of understanding by the farmer groups of their collective responsibilities. The collapse uncovered other deficiencies: for instance, loan approval processes that were so cumbersome that the loan was sometimes made too late to meet the agricultural input need for which it had been earmarked (such loans tended to be consumed, resulting in repayment difficulties).

Cooperatives, with their “one person, one vote” governance principle, are not inherently suited to a setup of disparity in resources among members. They may not be well adapted to absorbing external capital funds. Such drawbacks have contributed to the decision of the larger UK mutual financial institutions to convert to the joint-stock corporate structure. In contrast, though, many European mutuals have managed to innovate in corporate structure to get around these limitations. Already there are examples of such innovation in Africa, also. For example, *Crédit Mutuel* in Senegal launched a regional bank, BIMAO (*Banque des Institutions Mutualistes d’Afrique de l’Ouest*), that allows it to accept equity (as well as facilitating the provision of other banking services). What were until recently loose confederations of locally based savings and credit cooperatives in West Africa (such as *Nyesigiso* and *Kafo Jiginew* in Mali) have, while retaining mutuality, greatly centralized decision making in the national central offices of the networks.⁴¹ Kenya’s Cooperative Bank, initially established as a department in the ministry of cooperatives, evolved to become a kind of apex for Kenyan cooperatives as well as a stand-alone licensed bank.

As the power of the central office of the network grows, so the degree to which the member cooperatives are—in practice—being governed by the individual members diminishes. There is an interesting convergence of governance with the network of some 120 rural and community banks in Ghana. These commercial banks (with some restrictions on activities and geographic scope) are not mutual entities, but they formed an association in 1981 which, in turn, established in 2001 the ARB Apex Bank—now acting as a kind of head office (Andah 2005; Steel and Andah 2003).^{42, 43} It is not evident that a cooperative member of one of the large networks in Mali or one of the Kenyan cooperatives has a greater tie or is more respon-

sive to the local area in which it operates than is a locally owned rural bank in Ghana.

All in all, governments would be unwise to insist on the mutual organizational form, thereby shutting out the potential offered by other MFI sponsors. Legislative changes under way in the UEMOA have begun to reflect this view by dropping the presumption that MFIs will have a mutualist governance; hitherto MFIs that are not cooperatives have been able to apply for only a temporary five-year license (Lolila-Ramin 2005).

Mainstream Banks: Will Their Role Be Direct or as Wholesalers?

Following successes in microfinance by banks in other regions and the licensing as banks of a handful of African entities focused on SMEs and lower-income borrowers, some observers have suggested that the future for microfinance might lie with banks. If this proposition is intended to refer to the large international banks, it is far from clear that they will have an easy path to tread. Some of them do not have it as part of their business model. Others claim to have a retail strategy reaching further down the income scale and to micro, small, and medium-scale enterprises (MSMEs), but it is unclear just how far down this scale they can realistically hope to go.⁴⁴

In this regard, all eyes are on South Africa and the response of the banks and other leading financial institutions to the expectation that they can and should do more to achieve an inclusive financial system in that country.⁴⁵ It is a good testbed: the major banks are solid and skillful, the broader economic environment relatively strong. Yet access for the poor remains limited. Solutions that prove to be effective and financially viable in South Africa may be adaptable to the rest of the continent, after some of the setup and experimentation costs are incurred in South Africa.

Essentially the problem lies in unit costs. Catering for the small transaction costs involved in dealing with the poor can be prohibitively expensive for large international banks. The salaries they pay to their well-educated and well-trained staff members, needed because of the sophistication and complexity of some of their products (and the need for layers of review and control), make anything that involves personal intervention very costly. Technology can dramatically reduce per transaction costs, thereby offering a countervailing force, but putting the technology into effect in a sparsely populated region can also be prohibitively costly if the volume of transactions is not large enough. For example, the per transaction charges

made by South African banks even for the low-cost Mzansi accounts (equivalent to more than US\$0.50 for an ATM withdrawal and US\$0.35 for a PoS withdrawal or purchase) are affordable by lower-middle-income South Africans but are likely too expensive for the average Mozambican. To what extent banks can drive their costs further down to achieve greater outreach is unclear.

What can be envisaged, however, is a wholesaling function for large banks—to help get funding, as well as more sophisticated products, into the market. Already banks are acting as wholesale suppliers of mobilized resources to MFIs and cooperatives in several countries and, of course, they are the main conduit to the payments system. There have been some disappointing failures on the part of specialized lenders financed by banks—the case of Unibank and Saambou in South Africa is discussed in Rust (2002)—but some promising cases also.⁴⁶ The failures have partly reflected overconfidence on the part of the funds supplier about the information and management capacity of the primary lender. A particular difficulty arises in creating such links where the primary lender is donor aided, has little capital, or has finances so shaky that commercial lenders require a donor guarantee, which tends to defeat some of the purpose of the exercise. Fortunately, a growing number of solid MFIs do attract commercial bank lending without guarantees (Isern and Porteous 2005).

We have already mentioned the need for banks or other internationally active intermediaries to create the link with international reinsurance or bond markets needed to make some forms of agriculture-related insurance work by laying off the catastrophic end of the risk. Other forms of partnerships between mainstream banks and microfinance entities can be envisaged.

More generally, commercial banks could benefit from close links with MFIs. For example, lacking a formal credit record, small-scale or microentrepreneurs whose credit needs have outgrown the group-lending techniques of microfinance are unlikely to be able to access credit from a commercial bank where they are not known, unless there are some information or cofinancing arrangements between MFIs and banks.

Moving a notch down in scale from the large international banks, the prospects and, indeed, practice of microfinance engagement by local banks are considerably greater. It depends in part on the banks' missions and business models. Such entities as Centenary Rural Development Bank (CERUDEB) in Uganda; Equity Bank and K-Rep in Kenya; CRDB Bank

and Akiba Bank in Tanzania, Banque Nationale de Développement Agricole (BNDA) in Mali; Malawi Rural Finance Corporation (MFRC) in Malawi; Afriland Bank, BICEC, and Union Bank in Cameroon; and CNCA in Senegal have shown in different ways that licensed commercial banks in Africa can be effective in microfinance on a substantial scale. These are either microfinance or development specialists focused on a single country, but others such as the Bank of Africa and Ecobank, both present in multiple jurisdictions, are also increasingly involved in small-scale finance.

The National Microfinance Bank (NMB) in Tanzania represents a unique experiment in seeking to build on existing formal structures to reach a wider market. The NMB was carved out of the government-owned National Bank of Commerce when it was being recapitalized and privatized to Absa of South Africa. The NMB was established with a wide branch network—95 branches, of which all but 6 are outside Dar es Salaam—and an extensive deposit business. It had new systems, developed under management contract, with a focus on servicing households and MSME clients. Recently, partly privatized to a consortium led by Rabobank, the bank is gradually beginning to expand its loan portfolio.

Another promising model has been put into effect in Benin and Chad by Financial Bank (a banking group whose international dimension builds on the longstanding migration links between Chad and the coast) and in Zimbabwe by Kingdom Bank. It is the creation of a microfinance subsidiary that might ultimately be spun off into a freestanding unit. The differences in operating procedures and business culture can make this solution attractive (Isern and Porteous 2005; Kloepfinger-Todd 2005).

Commercial banks are not the only large, formal sector institutions that will play a part in increasing access in Africa. Post offices have already been mentioned. Post offices date back to the early colonial era and now vary considerably across Africa in the degree to and the success with which they offer financial services (World Bank and ING Bank forthcoming). The largest post office—that of Nigeria—does not currently offer financial services.

Many postal banks have lacked a customer focus, and some have not been well managed in even more serious ways—a common problem being lack of control over recording of liabilities in situations where passbooks are the legal record. Some have been left in an illiquid state by the government, with disastrous consequences for their ability to honor even the most basic financial contracts, such as repaying the depositor promptly.

But other African postal services have turned the corner and are displaying a promising dynamism. Where they are well managed, they have a considerable natural advantage to exploit their extensive locational network, as well as their information technology capacity to offer simple financial products (savings, payments) to poor customers. They are often the largest single provider of financial services in the country—for example, the Nampost in Namibia claims a 50 percent share of savings customers by number and about 13 percent by value; it has 190 offices across the country. In Benin, the total value of postal checking (CCP, or *compte chèque postal*) and postal saving (CNE, or *caisse nationale d'épargne*) accounts comes to the equivalent of more than half of bank deposits. As well as internal payments, often including the giro system, several offer international payments using the network of Western Union or other MTOs. Ensuring that they are not blocked from admission to the national payments system can help reduce the cost of retail payments.

Moving on to offering credit is being considered in a few cases. This is something that runs up against the political pressures discussed earlier, and it cannot be encouraged unhesitatingly. Some postal banks have been spun off from the post office proper, following the successful experience of a few European countries. However, this experiment has not always been successful, and it risks both increasing costs and undermining the built-in advantages that motivate the use of the post office as a financial service provider to begin with. Some spinoffs—such as that in Kenya, which serves an estimated 1.6 million savers—have concentrated their activities on a much smaller set of offices (about 70 in Kenya), without exploiting the full range of postal outlets (of which there are 900 in Kenya).

Large chains of goods retailers also enjoy some of the same advantages mentioned for the post office, although they do not typically have quite as broad a network of offices. Some African retailers have become interested in diversifying into offering some financial services to a broad clientele. Depository and payments services will, again, be their first products. Supermarket chains are beginning to show an interest in acquiring a limited banking license, which will enable them to offer such services.

Role of Governments: Consistency, Modesty, Regulatory Style

Competition, infrastructure, coordination

As we have discussed, government is often not itself the best-placed entity to deliver financial services (not least because of credibility and gover-

nance issues). Although some of the innovative institutions mentioned elsewhere in this chapter are state owned, these are exceptions that prove the rule. Nevertheless, in numerous ways, government actions can help enhance the quality and outreach of services. In addition to policy for prudential regulation, these actions can be grouped under the headings of promoting competition, providing infrastructure and other public goods, and coordinating.

For competition, maximizing the range of reliable providers and avoiding unnecessary cost impositions on suppliers are two central guiding principles. To take just one example, when the government needs to make payments in remote areas, putting that contract up for competitive tender rather than automatically continuing to use traditional channels can help build scale for new internal payments technologies and spur innovation.

Numerous dimensions of infrastructure, both hard and soft, that the financial sector needs will be provided only with government involvement. At the most basic level, political stability and physical security are fundamental to the ability of the financial system to operate. Many other infrastructural investments, such as those aimed at improvements in education⁴⁷ and in transport infrastructure, are needed also by dimensions of economic and social development. Electronic ICT in particular is crucial for enabling many financial innovations.

The meso-level infrastructures for finance, especially legal and informational infrastructures (discussed in chapter 3), remain relevant when it comes to finance for all. Accounting standards and practice, bankruptcy law, recourse to the courts to recover collateral—these infrastructures will all make important contributions. A clear and supportive legal basis for leasing, factoring, and hire-purchase is a particular low-cost reform that unlocks sizable possibilities. Both this and the creation of effective title registries and credit registries can be relevant for improving access to small-scale borrowing. The design and technology of national payments systems are relevant insofar as they help or hinder the competitive provision of low-cost retail payment services at the small scale. (For instance, interchange fees for card transactions that are set at a uniform per item rate can preclude their use by poor people.)

One classic type of public service that is very relevant for the effectiveness of finance is the public provision of small business development—in particular, agricultural extension.⁴⁸ These services are not always provided in the most effective way, and it may often be more effective to have them

delivered by the private sector, even if subsidized by the state. However, it is clear that there is too little knowledge of basic business methods and, in particular, of ways of making the most of existing financial services. Performance of publicly subsidized business development services is relatively easy to monitor quickly, so that governments can ensure that they are getting value for money. Such evaluations should be carried out on a regular basis.⁴⁹

Helping improve financial literacy is also important in ensuring that the poor make good use of the expanding opportunities and do not suffer from bad financial choices, including overborrowing. Financial literacy efforts can also, perhaps, yield dividends by laying the foundation for efforts to nurture norms for honoring financial contracts.

The introduction of new technology in finance has been pioneered by activist market participants, including NGOs, supported by donor funds and, in some cases, by government budgetary funds. The innovators have worked best when sponsored by agencies with strong governance that helped ensure that they would not be sidetracked from their goals. Policy makers need to understand these innovations to make sure that they do not inadvertently block them through regulation or undercut them with unsustainable and costly subsidies that chill market development without achieving their goal on any significant scale. Market participants will not explore such innovation unless the market is contestable. In short, policy needs to be designed so as to smooth the way for activists.

Even if governance weaknesses mean that a directly involved activist agenda in the financial sector cannot be recommended for most African government agencies, they can act as a broker or facilitator—"knocking heads together" to ensure that activist efforts by others are pooled or coordinated if this means that they could be more effective. Working with industry associations, the government can have an important role to play in overcoming coordination failures that hinder the adoption of shared market standards and financial market infrastructure, such as the establishment of credit bureaus or standardized mortgage contracts to facilitate securitization.

But it is harder for African governments to use policy levers successfully to exert pressure on private providers that are purely profit seeking and have no social goals to push outreach and financial access much beyond the point of profitability. In contrast to the situation in advanced economies, where a degree of legislative or moral pressure on financial

intermediaries can be effective and is in practice used to reduce financial exclusion, most African governments cannot assume that this is a viable or sensible way to proceed. To the extent that the problem is getting access percentages up from 10 or 20 percent (in contrast to advanced economies, where the challenge is to reduce exclusion from 10 or 15 percent), the tools and the time frames for achieving different goals need to be realistic. For one thing, given the small size of their markets, African governments have limited economic leverage on mainstream banks in a competitive environment. Too many impositions and the banks will downsize or exit the market.⁵⁰ As usual, South Africa provides an exception, with the banks there launching the Msanzi product at least partly to deflect political pressure. Indeed, even if the leverage of other governments remains modest, the South African case, if it continues to prove successful, now offers a focal point for moral suasion: if banks can reach out more effectively in South Africa, why not elsewhere on the continent?

Regulatory model

In addition to working proactively to create the conditions under which providers of financial services can work effectively, governments also strongly influence developments through the model of prudential regulation that they create. A degree of consensus exists about the main elements of a regulatory model for microfinance (Christen and others 2003), and African central banks have been at the fore in gaining acceptance for and putting in place a coherent regulatory framework for microfinance.⁵¹ Yet certain important ambiguities remain. The proliferation of small MFIs, whether cooperative, NGO-sponsored, or coming from other private initiatives, has created a bottleneck for regulators. In several countries, it has become clear that many are poorly managed and are struggling financially; this is undoubtedly also true elsewhere. This situation presents a dilemma for the regulator. On the one hand, small MFIs can hardly present systemic risks, especially if they do not take deposits. On the other hand, the relatively small scale of much terrorism financing means that small size does not preclude the use of an MFI for this purpose.

One overriding principle therefore seems important in guiding regulatory design in regard to MFIs, namely that regulation should not choke off initiative and outreach, especially in remote areas.⁵² A sense of proportion is needed with regard to fears of systemic distress and terrorism financing, with anti-money-laundering and combating the financing of terrorism

(AML–CFT) regulations adapted to the scale and functioning of each class of intermediary, as proposed in Isern, Deshpande, and van Doorn (2005). Only the largest deposit-taking MFIs need to be actively supervised for prudential reasons by the banking regulator. In this regard, for most countries, size should be measured by the number of depositing clients. More limited arrangements can be envisaged for the rest. Despite their recent growth and a tendency to concentration in the sector, arguably in no African country does any MFI have a balance sheet sufficiently large that its failure would entail contagion that would cause a wider financial sector meltdown.⁵³ Focusing on institutions with a large number of clients—and only on those that take deposits—is simply a rational allocation of limited supervisory resources to protect the interests of a large number of clients and also thereby protect social stability.

A new style emerging in Africa is to place MFIs that have sufficiently large capital in a separate regulatory category. The idea is that members of this class are at a scale with which the banks and the central bank can do business. They are more closely supervised than the other MFIs but may be allowed a broader range of activities (perhaps including a wider geographic spread for their lending and deposit-taking activities, permission to deal in foreign exchange, or permission to make larger individual loans). The idea of this additional tier is that these institutions—not having the capital or expertise to carry out the full range of banking services safely—cannot safely be allowed the full freedom of a banking license, yet are too big to be bypassed by prudential regulation.⁵⁴ Should this trend toward regulatory emphasis on larger institutions signal the death knell for smaller MFIs? Not yet. It is possible that, in time, one or two models of MFI will emerge as dominant. However, for the present, evidence is insufficient to allow one to conclude that, given the current economic and social environment in Africa, any one of the models has decisive disadvantages or merits.

To be sure, it is unlikely that an MFI sector that has wide outreach and is financially sustainable will in the long run be formed of small institutions. As is clear from econometric analyses of MFI sustainability, scale will prove essential for cost control (Honohan 2004). But the experimental stage that we observe implies that some potential giants of the future are now starting small. If we do not yet really know which model will dominate in the end, we cannot know which types of MFI deserve to grow.⁵⁵ The diversity of models in play at present likely facilitates product and process innovation. Given the current state of our knowledge, the fact that

the industry is still young, and how essential experimentation will continue to be in the search for successful and sustainable formulas for African conditions, it would be unwise to legislate prematurely for uniformity or to insist from the outset on large scale.

Regulators tend to be hostile to small institutions, and their suspicion is often justified. No fewer than 250 small MFIs were closed in Cameroon following the explosive growth of 1996 to 1999, though 85 percent of the sector remained informal or unregulated. But it was the largest network, FECECAM, that failed in Benin. So closing small entities is no guarantee of safety going forward.

For smaller MFIs, the ambitions of the regulators should be adapted to their means. Keeping an ear to the ground and visiting MFIs on a spot-check basis and in response to rumors or suspicions of which they become aware is as much as the supervisor of the smaller MFIs can hope to do. In many cases, the deficiencies reflect inadequate basic business and book-keeping skills: certainly improvements in financial transparency are badly needed. Identifying capacity-building needs and helping to provide them are two of the most fruitful functions of the supervisor.

Networks of cooperatives, credit unions, and rural banks, such as the Apex Bank of the Ghana Association of Rural Banks, already find it in their collective interest to employ inspectors who visit member MFIs on a regular basis to inspect and advise in a collegial manner. The incentive to do this will remain high as long as MFIs are neither explicitly nor implicitly covered by deposit insurance. Arranging that the official supervisor of the smaller MFIs, working with these networks and apex institutions, can draw in times of need on the staff resources of the main bank regulator will help ensure that any emerging crises can be met with adequate skills. Not all MFIs will be saved by this pragmatic approach, but the benefits in improved focus and cost saving will outweigh the costs, if any.

This more selectively targeted approach to supervision should be matched by a refocusing of regulation. Although it may be hard to design enforceable antimonopoly and consumer protection regulations, these goals should begin to receive greater attention. As well as raising prices, the introduction of technological innovations can be blocked by incumbents, especially with technologies that involve network effects such as the payments system. Furthermore, undue mechanical restrictions on the design and range of products that can be offered by banks and MFIs will stifle innovation that could promote outreach.⁵⁶ Artificial rules about the

classification of loans; excessive liquidity requirements; ownership restrictions (until recently, no individual private entity could own more than 20 percent of a bank in Uganda); and usury laws and other forms of interest ceilings can constrain banks and make MFIs reluctant to convert to banks, thereby limiting the range of services they can offer their clients.

Interest ceilings are particularly problematic. Although financial specialists universally agree on the damaging social effects of constraining ceilings on bank lending rates, the attempt to control rates has a recurrent populist attraction. Recent draft legislation in Kenya would, for example, have capped bank lending rates at 400 basis points above treasury bill rates, a measure that would have excluded a very large fraction of the potential borrowing market. Nigeria operates a ceiling at a similar level—400 basis points above the minimum rediscount rate—according to the mandatory “guide to bank charges” promulgated by the Central Bank of Nigeria (Charitonenko 2005).⁵⁷ The ceiling on bank lending rates in the CEMAC (Communauté Economique et Monétaire de l’Afrique Centrale) zone is currently 15 percent. Even the relatively high 27 percent usury ceiling for MFIs (18 percent for banks) in the UEMOA countries represents a constraint for MFIs in that region and is much lower than the rates of 50 to 80 percent per year that lenders in South Africa have commonly charged on small loans. To be sure, removal or relaxation of usury laws can be politically delicate. The approach adopted by the South African authorities, allowing registered lenders to charge higher rates (while leaving the usury ceilings on the books), had the merit of allowing greater transparency of high-rate lending and potentially preventing predatory lending practices while opening the door to effective microlending (Helms and Reille 2004).

Role of Donors: Resources, Innovation, Independence

Where do external donors fit in? First, of course, they can bring technology, human, and financial resources. Apart from capacity building and other institutional strengthening, donors can be sources of innovation and entrepreneurship. In addition, by exploiting their independence from local interest groups, they may be able to inject a degree of insulation from political pressure and serve to a degree as agencies of restraint. As such, they can venture further down the activist road than it is safe for governments to go. This is also true of a growing group of external providers of funds to microfinance and financial sector development generally (grants,

loans, guarantees, equity); they are outside the traditional donor group and may have a more commercial motivation.^{58,59}

Numerous examples of these elements have been cited throughout this chapter. Another illustration comes from the equity stakes taken by the International Finance Corporation (IFC) and other donors in small banks and MFIs in Africa. The donors too are affected by scale problems in this regard, especially where (as with the IFC) investments are intended to be remunerative. The equity stakes are small in financial value and cannot easily repay the inevitable minimum administrative costs involved in evaluating and monitoring them. It thus becomes important to supplement the purely financial engagement with an adequate budget for staff costs, while refining ways of evaluating the contribution of these costs to national development.

But the donors must be careful. Their scale often makes them like an elephant in the garden; when they move, locals may be trampled. How can they assist while maintaining incentives for private financial service providers to build their own technology and expand their market supply? How can they ensure that the costs of the assistance are limited to budgeted aid amounts? By now some of the most common causes of damaging side effects and of budget overruns are well known to donors and recipients, with subsidized interest rates topping the list of distortions.

Not all the new ideas in this area are wholly trouble free. For example, loan guarantee schemes are increasingly popular. It is important that they do not become just a covert way of providing sizable *de facto* interest subsidies to projects with what is in reality a high, but unacknowledged, default risk.⁶⁰ To the extent that the guarantee will not be called for several years, even unsuccessful schemes of this type can seem to be well performing for quite a while. The design of the guarantee can reduce the distortion, for example, if the guarantee applies to the first loss only and is not open ended.

Less fraught are such enabling interventions as—to draw on the recommendations of Pearce (2003)—brokering links between private sector participants, promoting farmers' associations, offering technical farm extension advice, and providing basic business development services. By funding setup costs as opposed to marginal costs, these kinds of intervention can avoid the most damaging distortions.

Innovative approaches to solving the problem of choosing which supplier should benefit from a proposed subsidy (perhaps having a competi-

tion in which alternative suppliers bid for the subsidy) need to be explored in finance as in other sectors. Indeed, the role of donors, including international financial intermediaries, in enhancing the flow of credit to small-scale borrowers is a delicate issue, given that donor sponsorship often drove the expansion of failing development finance institutions (DFIs) in the past. Most are keen not to repeat the errors of the past. Perhaps one way is to take a more engaged approach to the design and evaluation of onlending projects, to try to ensure that such projects are not undermined by favoritism in lending by the sublenders. This calls for increased efforts in capacity building and, in particular, attention to institutional design.

Finally, donors need to look at conditions in their own countries, notably with regard to international remittances. Do regulatory measures need to be taken to help ensure that the market for sending remittances to Africa is competitive and provides reliable services at low cost? The European Commission has been successful in driving improved international retail payments technologies and in ensuring lower consumer prices for these payments in the context of the European single currency. Could these ideas be extended to remittances toward Africa?

Notes

1. Porteous (2006a) discusses the failure of MFI interest rates to decline over time.
2. Data from <http://www.mixmarket.org> show that for the 57 elite African MFIs that report the relevant data to the MIX database, the average administrative cost per borrower in 2003 was US\$129 (median of US\$58). With such high unit costs, it is hard for MFIs to make small loans without relying on explicit or implicit subsidies. Nevertheless, there are indications that reliance on subsidies is falling. More MFIs are now reporting profitability, and with funders shifting to loans and equity, donor grants are not as common (Lafourcade and others 2005).
3. Here we include registered cooperatives and credit-only nongovernmental organizations as well as deposit-taking firms.
4. For financiers and their customers who prefer to deal only in products that comply with the more strict interpretations of Sharia law, a different set of innovations is appropriate. Islamic scholars are continuously refining Sharia-compliant products to achieve overall functionality comparable to that of interest-based finance and conventional insurance. Though growing, the use of these products in Africa remains very limited. The Web site of the Harvard Law School Islamic Finance Project is a valuable resource on this topic: <http://ifp.law.harvard.edu>.

5. For overall discussion of current issues in rural finance, see Kloeppinger-Todd (2005), Nagarajan and Meyer (2005), and Zeller (2003). At a more technical level, an authoritative and up-to-date survey of the economics of rural finance in developing countries, with numerous references to African studies, is in Conning and Udry (forthcoming).
6. Private merchants have taken on this role because parastatals have withdrawn in many countries. A late government entrant into this activity was that of Kenya in 1992, which displaced sugar factories as supplier of inputs on credit to smallholders in the sugar sector; the results were not sustainable, with heavy write-offs, and the government retreated after about a decade.
7. Because input loans are generally a small fraction of the value of output subsequently purchased, lenders can find even high default rates tolerable. Note that the risk of side sales is essentially confined to commodities whose supply chain does not have a natural constriction point.
8. Boot and Schmeits (2005) argue that (even though it has been diminishing in importance in advanced countries, except for the very largest deals) relationship banking remains at the heart of the competitive advantage of banks.
9. Not only underperforming economies rely on this type of relationship lending. Allen, Qian, and Qian (2005) and Allen and others (2006) note the importance of informal credit arrangements of this type in the rapidly growing Chinese and Indian economies.
10. The more recent wave of World Bank-sponsored investment climate surveys is also beginning to be analyzed in microeconomic analysis; see Eifert, Gelb, and Ramachandran (2006) and Moss, Ramachandran, and Shah (2004). Based on these surveys, Investment Climate Assessment reports have already been completed for a dozen African countries: Benin, Eritrea, Ethiopia, Kenya, Madagascar, Mali, Mauritius, Senegal, South Africa, Tanzania, Uganda, and Zambia, with Malawi soon to appear (<http://www.enterprisesurveys.org/ICAs.aspx>).
11. The excusable default concept is successfully applied also by one of the world's most effective development banks, Thailand's Bank for Agriculture and Agricultural Cooperatives (Townsend and Yaron 2001); see also Conning and Udry (forthcoming).
12. Credit networks of this type are widely observed to be confined within ethnic groups—reflecting an additional coping strategy of lenders in a difficult business environment. Ethnically limited credit networks restrict the opportunities for growth and productivity improvement (Eifert, Gelb, and Ramachandran 2006); to advocate greater use of relationship lending is in no way to advocate such limitations.
13. A savings account with a financial intermediary is a way of providing some insulation to the flow of household consumption in the event of an emergency. Hit by some losses or an urgent spending need (for medicine, funerals, and the like), a household will not escape the loss in total net present value terms, but temporary consumption compression can be avoided. If the household has access to emergency credit, that too will help.

14. International financial markets in insurance, commodity derivatives, and other products can be directly accessed only by very large entities such as governments. For example, during the food crisis of 2005 to 2006, the government of Malawi implemented an innovative approach to financial risk management of the food security response by purchasing a customized over-the-counter call option, based on South African Futures Exchange (SAFEX) quotations, to cap the price of maize imports. More challenging is making such risk management available widely through the economy.
15. Informal but well-organized insurance arrangements also exist, notably for funeral costs in Africa; see Dercon and others (2004).
16. The emphasis here on agricultural insurance should not hide the presence of other types of microinsurance in Africa. Life cover is often bundled with microcredit. Burial societies, often promoted by funeral companies, are particularly widespread in southern Africa. A variety of microinsurance schemes have emerged for health care, often managed on mutualist principles but often also involving the active participation of health providers, requiring the sponsorship and support of donors. They are sometimes linked with microfinance—indeed, emergency loans have sometimes displaced health microinsurance as the preferred response to health risks. See McCord and Osinde (2003) for East Africa and Louis (2006) for an interesting francophone case study. A valuable set of case studies, including several from Africa, can be found at <http://www.microinsurancecentre.org>. See also Preker, Scheffler, and Bassett (2006).
17. For example, tracking crop prices allows farmers to time the sale of produce. Farmers often do not know and therefore cannot get fair market prices. Internet technology can help (for example, the info kiosks piloted by PRIDE-Kenya's Drumnet scheme, which could ultimately be expanded to link into payments or even credit services).
18. Following Rutherford (2001), it is convenient to distinguish among three different types of eventuality for which savings are made by poor people: first, to deal with lumpy requirements of predictable life-cycle events (births, deaths, marriages, school fees, old age, and so on) and to cope with the timing mismatch between income receipts (for example, seasonal harvest receipts or the proceeds of the sale of an animal); second, to meet emergencies (sickness, injury, loss of employment, war, flood, and the like); and third, for opportunities (starting a business, acquiring assets, or buying radios, televisions, and so on). Life-cycle events are fairly predictable and liquidity of savings is not a major concern. By contrast, the need to finance emergencies requires liquid savings products. Even if households have the discipline to save at home to meet the diverse needs for lump sums of money at some point, saving at home is not a reliable mechanism. The money stored at home is susceptible to being dissipated in less valuable spending that arises in day-to-day household expenses, demands from relatives, or theft. The problem of losses of savings is documented for Uganda by Wright and Muteesassira (2001). They found that 99 percent of clients saving in the informal sector report losing some of their

savings; on average they lost 22 percent of the amount they had saved in the preceding year. A valuable collection of papers on financial saving mechanisms in Africa is in Wright (2003). Note, however, that precautionary savings in nonfinancial forms are important in Africa, as has been shown by extensive literature; a recent example is Kazianga and Udry (2005).

19. Checking accounts and credit cards represent payment technologies that do entail credit and that may not be as suitable for the poor as savings accounts and debit cards.
20. The pronounced inequality of living standards may have contributed here, because some banks competitively pursued the higher margins attainable from the upper echelons by offering high service quality and ambience not compatible with a crowded mass-market banking hall. Once such banks acknowledge the potential profitability of the mass market, though, they may continue to segment the market by offering exclusive luxurious physical facilities to customers with large balances.
21. Instead of mobile units, Botswana Saving Bank's electronic passbook for savers (which reduces fraud and speeds services) uses a low-cost ATM system and point-of-sale machines placed in selected post offices countrywide. It also relies on live telecommunications-a satellite system that provides much-improved geographic coverage throughout that vast and very sparsely populated country.
22. Long before the introduction of Mzansi accounts by a wider range of South African banks in the context of the Financial Sector Charter, Teba Bank had developed a low-fee, interest-bearing savings account targeted to low-income, predominantly unbanked and underbanked residents in rural South Africa.
23. The system was designed by a team originally convened by Hewlett-Packard and including representatives from ACCION International, Biz Credit, FINCA International, Grameen Technology Center, Freedom from Hunger, Global eChange, and PRIDE AFRICA (Firpo 2005).
24. South Africa-Wizzit, MTN (Mobile Telephone Networks), and Standard Bank and Kenya-Vodafone MPesa-also have cell-phone banking. There are some differences in functionality (such as the ability to work across different cell-phone networks) and in pricing and target market (Porteous 2006b).
25. For instance, there are no recent data for Cameroon, Côte d'Ivoire, the Democratic Republic of Congo, or Kenya, to take just the largest missing countries.
26. In addition to remitting funds to relatives at home, emigrants may place deposits on their own account in the banking system of their home country. Cape Verde's emigrant deposit scheme is the most remarkable example here, with such deposits (up until recently subsidized) amounting to 40 percent of M2 (Karpowicz 2006).
27. The potential for some steady remittance flows to form the basis for a favorable credit rating is largely lost when the funds flow to a cash point, as with MTOs, in contrast to being sent to a recipient's bank or MFI account.
28. One supplier, Ikobo, has expanded its debit card-based remittance technology to several African countries. This service allows senders to top up remotely a

- Visa debit card that has been sent to the recipient, who can immediately withdraw the money from ATMs in African cities. The service seems to be slightly cheaper than the MTOs. Top-up call time codes for some African cell-phone networks can also be purchased in the United Kingdom and other centers (and communicated by phone to the recipient). (Within Africa, call time can sometimes be transferred between user accounts for a small fee.)
29. The database of the CGAP has been augmented by Peachey and Roe (2005), who added more savings banks. The data presented in this study also incorporate some additional refinements, including those suggested by Honohan (2006).
 30. The overall household access percentage estimates presented in chapter 2 use a nonlinear function of account numbers that should help reduce the biases mentioned here.
 31. Interestingly, the aggregate ratio of MFI deposits to loans is much higher (at 72 percent) in Africa than elsewhere. In other words, the net role of external funds in financing the sector is smaller in Africa.
 32. Robinson (2006, 16) reviews the available evidence on the financial performance of leading African providers of microfinance: "Whether specialist organizations or multipurpose institutions, these microfinance providers are generally commercially funded and financially self-sufficient. They tend to have substantial assets and high loan repayment rates. And except for NGOs, their savings accounts typically outnumber their outstanding loans." She also notes that, by comparison with the very low per capita national income, staff salaries at African providers are exceptionally high in international comparisons, though this is offset by much higher productivity as measured by number of clients per staff member.
 33. The principles of mutuality are sometimes listed as democracy, participation, solidarity, autonomy, and liability. Case studies of African mutual financial institutions include Ouattara, Gonzalez-Vega, and Graham (1999).
 34. The traditional small-group approach, entailing forced lending and a highly regimented repayment schedule, has been criticized for imposing unnecessary transactions costs. Also, although group members may progress to larger loan sizes if the whole group repays on time, the model does not cater to varied evolution of client needs over time.
 35. FINCA and ACCION pioneered the village banking model. Sometimes the model relies partly on existing village authority structures for its governance.
 36. See Basu, Blavy, and Yulek (2004) for a useful overview.
 37. A recent statistical examination of the accounts of several hundred MFIs across the world suggests some interesting regularities (Cull, Demirgüç-Kunt, and Morduch 2005). Firms that use individual-based loans (in contrast to village-based lenders and those making group loans) tend to make larger loans. Only in the case of these individual-based lenders is revenue sensitive to interest rates. There is a positive relationship between labor cost and profitability but, again, only for the individual-based lenders, suggesting that they benefit from spending more on screening and monitoring while group- and village-based institutions do not. Given that individual-based lenders are able to exploit

- scale economies by making larger loans to their more creditworthy clients, it is not surprising that their portfolio is weighted toward less poor individuals.
38. Interestingly, the US\$300 figure is a higher percentage (89 percent) of per capita GNI than the average observed in Asia, Latin America, or the Middle East and North Africa. This partly reflects the lower income levels in Africa. But some African MFIs make extremely small loans. The average loan size for ASSOPIIL (Association pour la Promotion des Initiatives Locales) in Benin and for Bessfa RB in Ghana is US\$35 and US\$37, respectively. That both are profitable and large MFIs is due to their very high productivity—more than 1,000 borrowers per staff member in the case of ASSOPIIL.
 39. An instructive finding of Lafourcade and others (2005, figure 8) is that operating expenses represent a much higher proportion of total assets in southern Africa and the Indian Ocean area than is the case in the rest of Africa. Perhaps staff costs are disproportionately higher in the former subregions when compared with the average scale of loans.
 40. MGAs (following the postwar continental European model) have begun to emerge in some African countries (De Gobbi 2003). Sometimes sponsored by banks, sometimes by business associations, and sometimes with concrete support from governments, MGAs are a way for groups of SMEs to exploit their special knowledge of members' creditworthiness to guarantee members' borrowings from banks and other financial intermediaries.
 41. Other networks of mutuals began with a strong center, as in the case of PAME-CAS in Senegal, which, as reflected in the old name that gave it its acronym (Projet d'Appui aux Mutuelles d'Épargne et de Crédit au Sénégal), began as a donor-sponsored effort.
 42. Among other things, the ARB Apex Bank operates a very effective retail payments system for the rural banks.
 43. Somewhat surprisingly, there seems to be no corresponding apex institution yet for the 700 Nigerian community banks (Charitonenko 2005).
 44. If most mainstream financial intermediaries were to embrace the principles of sustainable finance, their contribution would be stronger. For a detailed and inspiring advocacy of this position for Africa, see Wood and de Cleene (2004).
 45. In October 2003, responding to actual or anticipated political pressure, South Africa's financial institutions adopted the Black Economic Empowerment Charter, including measures that will make banking services more accessible to low-income households—notably a simplified deposit account—the Mzansi account—offering lower charges and no overdraft facilities (unplanned use of which can prove disastrously costly for the poor). Some of the techniques that have been adopted to give effect to this charter are beginning to find their way into other parts of Africa.
 46. In an interesting experiment that might seem to clash with its somewhat conservative image, Barclays Bank has recently piloted an initiative in Ghana to make microloans to susu collectors for onlending to the collectors' clients. The Ghana Cooperative Susu Collectors Association, the self-regulated apex body of the susu collectors, identified 100 of its 4,000 members for the pilot and car-

- ried out preliminary screening of those borrowers. The Ghana Microfinance Institutions Network (GHAMFIN) facilitated capacity building for the susu collectors and a basic financial skills education program targeted to those who would be the ultimate borrowers. Noting that Ghana's susu collectors reflect a £75 million economy (equivalent to almost 2 percent of GDP) "thriving below the traditional banking radar," a Barclays news release implies that the program could be profitable at scale.
47. Education and investment in human capital are essential if financial technologies are to be adopted. Codified knowledge, like a credit-scoring or a mortgage-lending tool, requires significant levels of complementary human capital and tacit knowledge, such as ICT literacy, as well as an adequate organizational and management capacity.
 48. A contrasting example illustrating the damaging effects of some well-intended government policies is the case of free provision of fertilizer by the government to selected maize farmers in Zambia, which fatally undermined an otherwise promising market-based fertilizer credit scheme (Ruotsi 2003).
 49. Value-for-money calculations require considering not only the likely effectiveness of proposed spending (taking into account moral hazard and other potentially adverse unintended side effects), but also the opportunity cost (the value of alternative uses of public funds).
 50. The oft-discussed Indian experiment of the late 1970s and 1980s, when banks wishing to expand in the cities were obliged to match this growth with an expansion of their rural branch network (Burgess and Pande 2004), is a case in point. In few African cities is the prospect of opening an additional urban branch a sufficiently attractive proposition to induce a banker to open also in a rural area: such a policy risks backfiring and reducing branches and access overall.
 51. Among the most active have been the central banks of Ethiopia, Gambia, Kenya, Tanzania, Uganda, and the two CFA unions.
 52. An interesting case study of these concerns appears in Chiumya (2006).
 53. Even as nationally dominant an institution as FECECAM, with close to half a million beneficiaries, had deposits amounting to only about 7 percent of bank deposits in the latest year. This is not to imply that institutions with an MFI focus are negligible in terms of total liabilities. For instance, the following are among the top seven intermediaries in their countries, measured by total deposits: FECECAM (Benin); Faïtière des Unités Coop, or FUCEC (Togo); Fédération Nationale des Coopératives d'Épargne et de Crédit, or FENACOOPEC (Côte d'Ivoire); Crédit Mutuel (Senegal); Kafo Jiginew and Nyesigiso (Mali); Réseau des Caisses Populaires du Burkina, or RCPB (Burkina Faso); Cameroon Cooperative Credit Union League, or CAMCCUL, and Union Bank (Cameroon); and Bank of Africa (Madagascar). Many large MFIs also have substantial loans from banks.
 54. Proposals in South Africa for two new tiers of restricted core and narrow banks have a somewhat similar motivation, though driven more by a perception that

- existing minimum capital requirements for banks were a barrier to new entry in retail banking for low-income clients. The minimum capital required of the proposed new categories of bank would be smaller, at R 50 million and R 10 million, respectively, compared with the minimum for a full service bank of R 250 million. Essentially, in addition to providing transactions services, core banks would be allowed to take deposits and make secured loans; narrow banks would only take deposits. The helpfulness of such elaborate regulatory refinements in facilitating viable and socially useful entry would depend on national circumstances (FinMark Trust 2005).
55. Many African MFI regulators have become uneasy about the proliferation of small moneylenders masquerading under the name of MFIs but operating in the traditional manner of informal moneylenders everywhere. As in the past, the existence of a ready market for the services of these moneylenders reflects the limitations of formal finance.
 56. Electronic and cell-phone-based innovations in particular raise important regulatory questions that are well discussed in Porteous (2006b), who stresses the desirability of regulatory openness to innovation and regulatory certainty to give innovators the confidence to make the initial investment. With parts of Africa close to the technological frontier in some aspects of these developments, this area is likely to be a rapidly evolving one for advanced economy regulators also.
 57. See the Central Bank of Nigeria's circular dated April 23, 2004, available at <http://www.cenbank.org/out/circulars/bsd/2004/bsd-02-2004.pdf>.
 58. An important example of the new entrants in this field is the Investment Climate Facility for Africa (<http://www.investmentclimatefacility.org>), a joint endeavor involving several national governments as well as some major multinational business groups. Working with the support of the African Union in the context of the Africa Peer Review Mechanism process set up by the New Partnership for Africa's Development, the facility has financial markets as one of its eight priority areas and is explicitly set up with a view to exploiting this potential.
 59. As far as microfinance is concerned, 11 key principles have been endorsed by the Group of Eight, all 33 CGAP donor members, and many others: view them at <http://www.cgap.org/portal/site/CGAP/menuitem.64c03ec40a6d295067808010591010a0>. Collectively agreed guidelines for microfinance donors are set out at <http://www.cgap.org/portal/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/Documents/donorguidelines.pdf>.
 60. Some donors (for example, the U.S. Agency for International Development) have been using business development schemes (for example, one being carried out by Chemonics in Uganda) in coordination with their loan guarantee program, with the goal of bringing projects to the point where the risks are both lower and more easily calculated. It will be interesting to see how successful this model proves to be.

Policy Choices in Current Conditions

Introduction: The Vision

Appropriate affordable and sustainable financial services

The previous chapters have offered a vision of how financial systems in African countries could evolve over the years ahead—a financial sector delivering a more appropriate, affordable, and sustainable package of the services needed by African economies and societies. This evolution means more financial intermediaries that are backed by solid and reputable owners, have skilled management, and compete energetically and imaginatively for business on the basis of strict attention to cost control and knowledge of the local market and conditions. It also means an environment relevant to sound finance—the supporting infrastructures, legal and informational, for property rights that can support financial contracts.

Some of the services are needed by modern firms producing at high levels of productivity for an international as well as a domestic market. Only if the number and size of these firms grow can African economies hope both to absorb the growing numbers of young people entering the labor force in the years ahead¹ and to generate adequate incomes to lift them from absolute poverty.

Financial systems will also be needed to provide services at a small scale to meet the needs of low-income households, microenterprises, and subsistence and smallholder farming securely and at an affordable cost. These

services (together with specific improvements in other sectors) will contribute to the ability of the poor to ensure that the new generation has the health and education to participate fully in the opportunities created by the growing modern sector.²

There is no need to choose between growth and services

The dichotomy between financial services for growth and those for outreach was clear enough in the past in terms of which institutions catered to which market. But increasingly the dividing line has become blurred, and this trend will continue. One reason is the middle market of small- and medium-scale enterprises that now function at the margins of the formal economy and that are often treated by banks as informal and unbankable entities. These enterprises must increasingly move upscale in terms of their business practices—including their accounting and their engagement with the official sphere—eventually graduating into a higher league of productivity and competitiveness. Another is that increasing awareness of the profit potential at the bottom of the pyramid will result in formal intermediaries moving downscale even as microfinance specialists grow up with their clients. Thus, as has already begun to happen in some countries, some microfinance institutions (MFIs) will become banks and some banks will become market leaders in catering to low-income groups. Meanwhile, the emergence of strong financial intermediaries whose goal is to seek out profitable and secure uses for their funds will offer energetic entrepreneurs a way of securing the finance needed for their growth without having to seek political patronage or a disadvantageous alliance with incumbents.

Governments are better equipped to enable market functioning than to participate in it

Although this vision sees a major role for private activity—reflecting a view that finance is a sector that is uniquely sensitive to adverse and unintended side effects of misconceived government and political intervention—government has a major policy role in seeing that this vision is accomplished. As this report has stressed throughout, the most rewarding task for government is not to try to substitute for the market but instead to enable and encourage market functioning by building the overall environment and the specific meso-level infrastructures needed by market participants. The activities of donors are often important in influencing the

shape of government policies, at least at the technical level, and they, too, need to consider how to contribute to the achievement of the vision.

From Vision to Policy

The goal of this study has been to present a considered review of the challenges and opportunities for financial sector policy in African countries. By now it will be clear that the approach adopted does not lead to a brief checklist of easily accomplished items to be implemented. Any checklist can appear both depressingly long and full of hard-to-accomplish elements.

Indeed, most African countries have, in the past couple of decades, been reforming fundamental banking and central banking laws, as well as their counterparts underpinning the insurance and securities markets. Some of these countries have enacted laws defining and clarifying the operation of mutual funds, leasing companies, and wholesale payments systems, among others, so that the relevant intermediaries can do business without fear that lack of legal certainty will result in unexpected consequences. Legislation underpinning the modern use of collateral and governing insolvency has also been on the agenda, as of course has the whole vexed area of ownership and rights over the use of land. All these efforts are essential to improve legal certainty, without which financial contracts become too risky for all parties.

Meanwhile, regulatory structures have had to be designed and staffed with adequately trained professionals, not only for banks but also for microfinance institutions, whose solvency their clients have little chance of evaluating. Failing banks have had to be restructured, recapitalized, and placed under reputable management and ownership.

All these measures have been necessary and have in most cases only been partially accomplished. Each step has been partly technical, but most have also involved tactical and political choices. Should entry be blocked to give breathing space for incumbents to consolidate? Should entities controlled by nationals be given preference over foreigners in the hope that they might act in the national interest? Is finance so sensitive that everything must be built to the most complex prevailing standards, or are shortcuts permissible and desirable? The reasoning of this report does suggest answers, or at least an orientation to such tactical questions.

Thus, a three-stranded common thread runs through the policy discussion of this report.

- First, while not neglecting to build for the long term, *shortcuts* can be taken that will allow African financial systems to deliver the most essential services faster, without compromising on stability and efficiency.
- Second, openness must be maintained to what the *outside world* can offer, whether in the form of regional cooperation at the policy level or the provision of services by foreign institutions.
- Third, the value of approaching policy with attention to *inclusiveness* as a goal must be understood.

Shortcuts

The bedrock of any coherent vision of what an African financial system should aspire to is certainly defined in large part by what has been achieved in advanced economies,³ building on solid legal and information foundations. What has been referred to previously as the modernist agenda is what is needed for the long term. Fleshing out that agenda and helping make it a reality over time are what external advisers (including the World Bank) spend most of their time discussing with policy makers. And rightly so. Many of the elements take a long time to put in place. That is not only why making a start on them is important but also why seeking the shortcuts and ensuring that quick-yielding measures receive sufficient priority are important.

The suggestion that information infrastructures may yield greater benefits than legal reform in low-income countries with sizable governance deficits is an example of such a shortcut involving choices and prioritization as between different elements of the modernist agenda.

Another example is in the idea that regulation of securities markets might be more successful in most African markets if it begins with the lighter regulatory touch typical of second-board markets in advanced economies. Likewise, avoidance of the complexities that would be introduced by most variants of the Basel II capital framework for bank regulation is suggested for now. More generally, the desirability of adapting regulatory structures to local needs and capacities is something that needs to be acknowledged more than it has been, though it must not, of course, be an excuse for a semideliberate opening of loopholes that could reintro-

duce the carelessness and self-dealing that have caused many intermediary failures in the past.

Most of the activist agenda can be seen as a shortcut, for which advanced financial systems have less need (though even these suffer from market failures requiring correction, as has been mentioned). The prominence of the activist agenda is thus likely to subside over time as structural weaknesses are progressively corrected. For the moment, though, getting an effective financial system is a struggle, not something that will happen of its own accord.

But strengthening governance is crucial where activism is being tried. If state-owned development finance institutions (and credit guarantee schemes) have failed for lack of adequate governance in the past, one must be alert to the danger that social security funds, newly encouraged to contribute to the provision of long-term and risk finance, could slip down the same path if their good governance is not ensured.

External Agency

At several points in the discussion, we have argued that external agencies can make up for what is lacking at home. They can offer improved governance through their relative independence from national political pressures. They can offer risk pooling and avoid the diseconomies of small national scale. They can bring technology and help build human capital. This argument applies to regional organizations, to foreign-owned financial intermediaries and markets, and to donors.

Exploring the potential benefits of internationalization, whether regional or global, should be a requirement for policy design in any aspect of finance for African countries. Can the sought-for improvement be achieved more effectively or more cheaply through some form of outsourcing or through regional cooperation? *Foreign* does not necessarily mean *good*, even in finance, and the potential downsides, whether in terms of the sizable coordination costs involved in regionalization or the excessive macroeconomic volatility that might be introduced by premature capital account liberalization, must be carefully calculated. But in many—if not most—cases, the benefits easily outweigh the costs, and many objections (such as the fear that locals will not learn the relevant skills if services are being provided by foreign institutions) prove on examination to be groundless. Managing populist doubts here is a challenge for advisers and even more so for national politicians.

Inclusiveness

Though it may not seem so, conventional financial reform is a potentially radical undertaking, which may be subversive of incumbent interests as it transforms the economy and society by giving opportunities to all. Who can doubt that some such transformation is needed in most African economies today? A society in which all have a clear stake in underwriting sustained economic growth—both the existing elites, who craft policy, and the poor, whose horizons can be substantially lifted only by the assurance of a reasonable share in expanded general prosperity—is the only type of society that will prosper in the decades ahead. Inclusiveness is therefore also a criterion against which policy stances must be evaluated.

Facilitating the extension of microfinance to a wider clientele requires the action not just of the government in ensuring that innovators are not hampered by uncalled-for rules but also of sponsors and intermediaries. The latter must innovate to reduce unit costs and to meet the barriers of scale and remoteness, but they must also ensure that successful innovations are sustained and scaled up, thereby helping achieve inclusiveness by avoiding the syndrome of repeated small-scale initiatives that run out of steam because follow-up is less glamorous than trailblazing.

Inclusiveness is also generated by ensuring a sufficient population of competitive service providers. Otherwise incumbents will restrict themselves to those customers that are easiest to serve. Instead of protecting incumbents from new entrants, many—though not all—African policy makers have wisely been welcoming entry by reputable service providers.

Where Should Government Begin?—Two Attainable Goals

As every country that has participated in the World Bank–International Monetary Fund Financial Sector Assessment Program (FSAP)⁴ is well aware, bringing legal and regulatory structures into compliance with best practice—as defined by international regulatory bodies and expert opinion—can be a daunting task. Indeed, for many countries, limited administrative resources mean the task is impossible to accomplish within a short time frame. The task implies more than just adjusting laws and more than accomplishing institutional changes (within court systems, registries, and the like). It can also involve political upheaval because of the power shifts that might result. So prioritization is necessary. There are two

important directions in which valuable results can often be obtained at relatively low cost—whether political or administrative.

Boost Credit Flows by Strengthening Registries and Streamlining Court Procedures

Given the frequent coexistence of high liquidity and a credit crunch—with bankers in some countries actively discouraging deposits, a lowering of deposit rates, and a widening of spreads—improving the conditions that will help increase the flow of credit to the middle market could be the top priority for many African economies. One dimension to the solution is more innovative use of lending technologies, some of which have been discussed in chapter 4. But much of that lies in the hands of the intermediaries themselves. What can government do? Given the greater freedom now allowed in the determination of interest rates in many African countries and the much lower rates of inflation that now prevail, financial repression and macroeconomic instability may no longer be top of the list of the barriers to increased bank lending—although this situation could change and requires continued vigilance by policy makers. Instead, a number of other needed steps loom larger, several of which have already been alluded to in chapter 3. Taking these steps will help both stability of the financial system and development.

The functioning of registries—of land, of claims on movable assets, of credit records—needs improvement almost everywhere. In many cases, this improvement includes enacting supporting legislation. Closely related are the special pieces of legislation needed to underpin leasing and an expansion of the mortgage market. These too deserve to be considered early on. Some African countries have recently embarked on vigorous efforts along these lines, and an opportunity will soon exist to take stock at a nuts-and-bolts level of the degree of success here (as in other specific areas) to learn from such an evaluation about what works best in African conditions; carrying out such a stock-taking soon is on the World Bank's agenda.

Improving court procedures is, of course, more challenging. In particular, where corruption infects the courts, progress toward effective reform will be slow. But some simple procedural changes can help. The inefficient court procedures behind which delinquent borrowers (that could, but will not, repay) hide can be dismantled—again often requiring legislation and

more. The quality of court judgments may be improved by training and perhaps by instituting a special commercial court.

This task is not trivial. Populist opposition to any pro-creditor reforms is likely to be stirred up by vested interests, and the reforms are unlikely to be enacted without vigorous and skilled political championship. Packaging such reforms with a national strategy for expanding the coverage of micro-finance could be one way of building consensus around this aspect of the modernist agenda.⁵

Establish Independent Supervision

A politically dependent supervisory agency can be worse than useless, not least by protecting inefficient incumbents from competition. For example, at present, the laws on banking and central banking in many African countries do not give the monetary authority or the banking regulator sufficient operational independence from politicians—and from the banks—to do a good job. The importance of such independence was not yet evident when these laws—often modeled ultimately on since-revised laws of the United Kingdom or France—were enacted.⁶

Yet too much discretionary power in the hands of the banking regulator also can be damaging, and independence of the monetary authority presupposes a free press and an informed public opinion. Accountability is a necessary companion of independence. Accountability, in turn, requires a clear understanding of the goals of the regulator (as with the monetary authority). These goals should envisage facilitating entry of solid intermediaries, thereby enhancing competition. If systemic crises are to be avoided, creating the conditions for greater reliance on market discipline as a complement to official supervision is likely to yield the best results.

If they are to be independent, the banking regulator and the monetary authority need to have commensurate skills and administrative capacity. Here is a delicate balance. In the case of the bank regulator, the marginal benefit of having an additional trained and experienced supervisory staff can seem small in the years between crises, but the value of having one to head off an incipient crisis, or to deal with a crisis when it hits, is high. That is one reason for advocating regional cooperative arrangements in bank regulation (as discussed above). As for the monetary authority, the central bank of many African countries seems to be the best-resourced agency, typically because of the nature of its balance sheet and its ability to dip into

seigniorage to cover administrative costs. On the one hand, these resources are sometimes used to create a center of excellence for guiding a wide range of financial policy, not just monetary policy. On the other hand, some of these institutions might have exercised more moderation in their office-building programs. Other central banks labor under the burden of having absorbed the cost of a banking or fiscal crisis and no longer enjoy financial independence, let alone operational or policy independence.

As for the regulation of nonbank finance, a lighter touch to capital market regulation may be appropriate for many African countries. And although insurance and pensions are increasingly important, the complexity of insurance accounting and the still small size of the insurance market argue for recognizing that it may not be feasible to staff the insurance regulator's office to a level that would ensure a high probability that abuses will be forestalled; *caveat emptor* must remain important for this sector.

The design of prudential regulation for microfinance has become quite a fraught issue in recent years, despite consensus on some principles. The main problems seem to be the diversity and multiplicity of MFIs and a tendency for newly established regulators to overreach and micromanage. Two presumptions may be useful to guide policy in most African countries: (a) non-deposit-taking MFIs do not require prudential regulation and (b) delegated monitoring to umbrella institutions of networks of mutuals or cooperatives can help reduce the central burden of supervision to a practical level. Finally, regulatory design needs to recognize that banks (moving downmarket) and MFIs (moving upmarket) will increasingly compete in the middle market. Regulation of the two in markets where they are both active should be conducive to a healthy competition between them.

Contrasting Initial Conditions

Given the diversity of initial conditions in different African countries, will one size fit all in policy design? Yes and no: yes, insofar as the goal is relying heavily on a self-sustaining, market-driven financial system to make many of the major allocative decisions in the economy; no, in that transplanting some specific practices (such as Basel II's new method for calculating bank capital) into an environment lacking key prerequisites would be a mistake—and also in that priorities will be different for Africa and between different countries within Africa, depending on initial conditions.

Thus, although all African countries face similar issues to a greater or lesser extent, the relative weight to be attached to different aspects will depend on local conditions. For instance, just five different country characteristics immediately point to the different priorities that need to inform the design and timing of policy reforms:⁷

- Postconflict countries
- Sparsely populated countries
- Small countries
- Oil-rich countries
- Countries with critical mass

Postconflict Countries

The resilience of some financial transactions in states whose governments have been overwhelmed by conflict has been remarked upon by some as an illustration of the resilience of the private financial sector and its ability to deliver some services even without the support of the state.⁸ But for the most part, the effective range of the formal financial sector in conflict-ridden countries typically shrinks to a limited geographic zone, as up-country branches of banks are abandoned. Most banks indeed collapse altogether or teeter on the brink of insolvency, their liquidity dependent on monetary financing of the government's deficit. The currency notes deteriorate physically and have to compete with the introduction of a parallel or forged currency by insurgent groups.

Among the priorities for the new government is the reestablishment of credibility of the currency, supported by a fair, consistent, and transparent treatment of the problems of preexisting currency notes and by a coherent and credible macroeconomic and monetary policy framework.⁹

Reentry of bankers of substance will present several different challenges. Some of the old bankers will have left for good, but others may wish to reenter, even though their old banks had failed. Can they be considered fit and proper?

The chaos may have created an opportunity for shady transactions to be routed through what was left of the financial system, and even the perception that this could be so, will mean that AML-CFT (anti-money-laundering and combating the financing of terrorism) procedures will have

to be put in place earlier than otherwise if this proves necessary to reestablish the country's banking links with international correspondents.

The domestic payments system is likely to require reconstruction from bottom up. If security is still questionable in up-country locations and no bank branches exist yet, the government will have difficulty in making payments, including to its employees. Post offices may not yet be functioning, and in their absence no alternative may exist to having the central bank provide check-cashing facilities on a temporary basis. Eventually, banks will return to the main outlying towns, especially if they are offered a realistic fee for cashing government checks. Electronic payments using mobile-phone technology—which is likely to be one of the first services reaching a wide geographic coverage—and points of sale in a handful of stores in the larger towns may prove feasible at a relatively early date. (The legal texts that would be desirable to place electronic payments on a secure basis may not be strictly necessary to underpin this system at first but will be needed in due course.)¹⁰

Sparsely Populated Countries

The many sparsely populated countries in Africa display some similarities to postconflict countries in terms of communications difficulties. Here too, then, electronic retail payments and mobile telephony offer a great opportunity. To ensure that these technologies are exploited, policy makers must avoid lock-in to a particular limited technology (some of the systems now being rolled out are a lot more capable than others) or to systems that cannot communicate with each other, to enact the legislation that will make banks and others that use these systems feel secure in their rights, and to remove unneeded banking regulations that might impede the adoption of these technologies.

Many African countries are in the process of introducing highly secure, speedy, and effective wholesale payments systems. The effort should not stop there; indeed, improving retail payments effectiveness is a higher priority for many African countries.

A distributed architecture of the financial system is likely to be an essential feature of sparsely populated countries, though this feature depends on how the population is actually distributed. In some countries, like Chad or Niger, large parts of the country are almost totally uninhabited, with most of the population concentrated in or near a relatively small number of cen-

ters. In time, the network of viable bank branches conceivably could blanket these centers. In Tanzania, by contrast, the population is scattered across a large number of isolated settlements. The bulk of the population there will remain as at present—quite far from a bank branch.¹¹ This situation means that access for a large fraction of the population can be only through MFIs or some form of agencies. The role of governments in smoothing the way for such arrangements is not only regulatory. Ingenuity will be needed to ensure that any subsidies they choose to provide—or the contracts for effecting government payments in rural areas—are designed in a way that offers a level playing field, so that the most efficient financial service providers will end up delivering each aspect of the service. This system may well result in a distributed architecture, with larger institutions such as banks, MFI-network umbrella organizations, or the post office taking the contract and subcontracting parts of it to rural agencies, including MFIs.

Small Countries

Small size presents a somewhat different set of tradeoffs. Here the inability to exploit economies of scale onshore and the tendency of the few providers to exploit monopoly power naturally point to sourcing services—both market and regulatory—offshore. These countries need some way of overcoming the diseconomies of insufficient scale, including the lack of competition between different financial service providers. Policy makers will want to err on the side of increased openness to entry from reputable foreign financial service providers, even if they are clearly going to rely heavily on their parent companies abroad for shared technology, management, and back-office and even credit-approval services.

An alliance with a nearby securities exchange, possibly aiming at the creation of a satellite of the foreign exchange, will also be worth exploring if the country does not have its own—and even if it does. This arrangement can raise exchange control issues for both countries to the extent that dealings on the satellite exchange could be used to export funds, but these issues will become less and less important as reliance on exchange controls diminishes.

The smaller the country, the more attractive regional cooperation on prudential regulation of banks and other intermediaries becomes, and outsourcing these functions to multinational organization can be a very viable

solution. To an extent, these advantages of outsourcing have long been recognized by small African countries as different as Guinea-Bissau and Lesotho. But the potential has not yet been altogether fulfilled.

Oil-Rich Countries

Several African countries have been enjoying a sizable boom in the value of oil exports. For the smaller countries in this group, the effects on paper are astonishing. Indeed, Equatorial Guinea may have had the second-highest per capita gross domestic product in the world in 2005. Yet the rest of the economy has little enough to show for these gains. To be sure, the local banks are doing well out of fees charged on international transfers associated with the oil business, even though most of that business is financed offshore. Financial sector policy can have a role both in limiting the Dutch-disease effects of overvaluation that have been seen elsewhere with oil booms and as a mechanism for channeling some of these resources into the financing of productive investment—which in turn can help increase productivity and output in the nonoil sector.

Apart from monetary and exchange rate policy, the issues here are those of the governance of public funds, such as pension and social security funds writ large. These, more than banking or stock exchange issues, will assume priority in the minds of financial sector policy makers.

Countries with Critical Mass

A few African countries have the scale to consider providing a wider range of services onshore and putting in place a more comprehensive administrative and regulatory framework. Policy makers can be more ambitious in the nature and form of their policy initiatives. Kenya and Nigeria have joined South Africa in this category now, and the discussion would be also relevant for some others, increasingly so over time.

The ability of financial sector policy makers in larger economies to strike a distinctive policy note and hold to it has been most dramatically illustrated by the capital adequacy ruling of the Central Bank of Nigeria.¹² This experience shows several features of larger financial systems:

- First, the ability to be innovative and to design policies that are relevant to national needs without frightening away the major participants. In a smaller market, most banks would have chosen to exit the market

rather than put up so much capital, but the franchise value of a bank license—its potential profitability—means that Nigerian banks complied.

- Second, the value of a domestic stock market, even in a matter that was primarily for banking. For all the belittling of Africa's stock markets that one hears, the Nigerian stock exchange did manage to raise about US\$3 billion toward the recapitalization of the banks. The banks might have had difficulty in raising such funds if they had to rely on a private equity market and might have paid a lot more in fees and in information discount if they had listed on the Johannesburg or London exchange. Once again, the limitations of a small exchange are relative.
- Finally, the role of an active public debate among financial sector specialists and the policy-aware public. Not only was the policy floated first for discussion before being finalized, but also it was extensively and freely debated in the public media. This kind of transparency and consultation in policy formation may not result in as vigorous or informative a debate in smaller countries, but it is a costless and valuable approach.

These reflections emphasize how financial sector policy makers can be more ambitious and comprehensive in their policy formulation. These steps include efforts to improve competitiveness and to sanction abuses of market conduct regulation. (In smaller economies, regulators often do not have an effective way of ensuring that profit-reducing regulations are really enforced: the prospect of lower profits may merely trigger exit.)

Thus, larger countries can be the pioneers in upgrading the market conduct of financial intermediaries and markets. The formation or reactivation of consumer and producer consultative groups could help in the design of such policies. These policies could include not only the market conduct rules that should underpin a well-functioning stock exchange but also regulations designed to curb predatory lending and to promote access of lower-income groups to financial services. Here, recently enacted legislation and the financial sector charter in South Africa offer an interesting model. The adaptation and application of such legislation north of the Limpopo River could begin in the larger economies, and it should have at least a demonstration effect everywhere.

A combination of modernism and activism, each tempered by an awareness of the limitations of the institutional preconditions in most African countries, will do best in guiding the move toward stronger and more effective financial systems. These limitations include the stretched administrative resources of governments and the weakness of governance institutions, such as institutions of financial oversight. These limitations imply that highly complex regulatory designs are unlikely to be operated effectively and that hands-on government involvement in credit allocation, or generally in the ownership of financial intermediaries, is more likely to be subverted in favor of special interests.

Delivering the infrastructures for the modernization agenda while ensuring that the door is left open for activists—local or foreign, profit-seeking or charitable—is the main agenda for government and its agencies. The agenda is demanding, not only because of its technical complexity and the need to respond to changes in the international environment, but also because it lacks the kind of dramatic initiative that helps secure political support.

Nevertheless, persistence and ingenuity will be repaid given the central importance, for achieving development goals, of making finance work for Africa.

Notes

1. According to United Nations projections, the population in age groups 15 to 59 in Sub-Saharan Africa will grow from 401 million in 2005 to 514 million in 2015 and 656 million in 2025. Although the absolute increases continue to grow, the rate of growth decade by decade has already peaked (at almost 34 percent in the decade ending in 1995).
2. At present, almost one-third of the more than 80 million children in the 10 to 14 age group in Sub-Saharan Africa (excluding South Africa) work in the labor force.
3. To argue that modern finance represents a relatively coherent long-term objective for African financial sector policy makers is not to deny that advanced financial systems have experienced failure. Most advanced economies experienced severe banking collapses in the 1980s or 1990s, resulting in a new emphasis on capital adequacy. The misleading information provided to stock exchange participants and other customers by prominent financial firms in the late 1990s and early 2000s has led to a series of high-profile indictments and extensive regulatory change.

4. Twenty African countries (plus the Communauté Économique et Monétaire de l'Afrique Centrale union) have already participated in the FSAP since 2000. Three countries have already had follow-up assessments.
5. Although the seemingly high interest rates necessarily charged by microfinance companies risks being a stumbling block here, MFIs need to attend to their public image as they expand their coverage, or they too could become unpopular.
6. Anti-money-laundering and combating of financing of terrorism laws and arrangements are being modernized in many countries under international pressure to improve financial integrity.
7. A sixth category—offshore centers—applies only to Mauritius, the Seychelles, and perhaps Cape Verde at present and will not be discussed further here.
8. The case of Somalia is often mentioned, though some other aspects of the economy were considerably more resilient than the financial sector (see Mubarak 2003; Nenova and Harford 2004).
9. Addison, Le Billon, and Murshed (2001) and Addison and others (2005) provide overviews of the issues, with examples from African experiences, including those of Angola, Burundi, the Democratic Republic of Congo, the Republic of Congo, Eritrea, Ethiopia, Liberia, Rwanda, and Somalia.
10. A valuable literature survey of postconflict microfinance is in Nagarajan and McNulty (2004).
11. Although there are 200 bank branches in Tanzania, the mean distance (over all rural households) to the nearest bank branch is 38 kilometers.
12. The policy was announced by Charles Soludo, executive governor of the Central Bank of Nigeria, within a month of his appointment in 2004. He described it as “preliminary thoughts on the major elements of the reforms by the CBN [Central Bank of Nigeria]” on which comments and suggestions of the committee of bankers were solicited “before we finalize them.” But the main features were maintained, even to extent of the timetable and the banking consolidation (every bank with a capital of at least the equivalent of about US\$200 million—an exceptionally high figure by international standards). See <http://www.cenbank.org/documents/speeches.asp>.

African Relationship Lending

Intrafirm credit represents a large fraction of firm financing, especially for small firms and others with limited access to bank finance. Successful credit providers in Africa recognize the continuing importance of a relationship model of credit. Such lenders rely on (a) multidimensional evaluations of creditworthiness in making the loan or credit sale and (b) flexible enforcement (Fafchamps 2004; see also Biggs and Shah 2006).

Credit Appraisal

Acquiring information is time consuming and costly. It also presupposes that the lender is embedded in the local economy. First, the lender needs to know about the borrower's ability to deliver high-quality goods and services to the market. Then the lender needs to know whether the borrower has a good business reputation and would be reluctant to lose it (see box A.1).¹ And last, the lender needs to know if the borrower's ethical character and ability to dissimulate make it unlikely that the borrower will conceal a capacity to repay.

Modern credit-scoring techniques implicitly include some indicators that are correlated with those characteristics, even though they are only very indirectly correlated, on the basis of past repayment record, and are not at the level of detail accumulated by painstaking, face-to-face observation of the borrower in multiple economic and social interactions. The most important

BOX A.1

Reputation

Reputation is a widely discussed aspect of credit within tightly knit communities. Scholars of contemporary and historical businesses have explored the ways in which a poor payment record of one member of even a far-flung network of merchants can be reported and result in ostracism from the whole group (Greif 1993). By reporting a default, an aggrieved creditor spreads the bad reputation of the delinquent; the threat of this happening amplifies the costs of default and reduces its incidence.

These reputation networks are generally formed of people with a common ethnicity—Lebanese and Syrian in many countries of West Africa, Asante in Ghana, and others. At the same time, it is commonly observed that foreign firms find it difficult to deal with African firms and find them generally unreliable, and several studies find stronger credit channels within rather than across ethnicities.

This issue has led some people to believe that trust and reputation are inherently ethnically based and that they have no likely or beneficial place in a pluralist financial system. However, it is important to not overstate the role of ethnicity in underlying effective credit flows in Africa. Indeed, the role of ethnicity in supporting credit and other business relationships is often misunderstood. It is not a question of ethnic solidarity. Social networks in Africa are not coterminous with ethnic groups. Ethnic business networks are much smaller than the ethnicities—they are historically created subgroups, not ethnically determined subgroups.

source of this kind of information is the history of successful exchanges. Once trust has been built in this way, it represents a valuable bilateral relationship that can underpin future lending. Reflecting this trust, surprisingly lengthy credit relationships predominate in African markets (Fafchamps 2004).

Enforcement

Having made the loan, lenders find that enforcement proves to be deliberately flexible in the business environment prevailing in most African coun-

tries. In the interfirm credit market studied by Fafchamps (2004) and his collaborators, lenders recognize that many uncertainties (weather or transport difficulties are two of the most common) can affect borrowers' ability to repay on time. Nonculpable delays or excusable breaches of contract are therefore automatically excused. Lenders don't regard a delay of even a few weeks to be at all significant. Indeed, in especially uncertain environments, no specific repayment date may be specified. Even after the due date, lenders wait for payment. And a delay does not imply a high probability of nonpayment: typically 80 or 90 percent of delayed interfirm payments eventually come in.

Eventually, when there is a prospect of being repaid, the lender will take some actions. In few African countries does this problem often involve recourse to courts or lawyers (Fafchamps 2004, table 4.5).² Instead, when repayment seems possible, the lender will begin to harass or closely monitor the borrower, often turning up on market day or payday, when the borrower might be more likely to have liquidity, to see if the ability to repay has improved. Renegotiation of the loan is also possible at this stage.

Lenders and traders also report other forms of sanction for slow payers. Borrowers cannot expect to get the best deals or priority deliveries when certain goods are scarce. The business relationship is thus a form of business collateral. Ensuring its maintenance is an incentive for debtors to repay. This relationship, of course, suggests and requires a degree of monopoly power for the lender, pointing to the social cost of a credit system that is built on such a costly structure of information gathering.

Notes

1. For centuries, some societies and ethnic groups have cultivated a practice of publicizing and punishing defaults among their members. Some such conventions may partly explain the higher degree of intraethnic group credit observed in some African countries (Fisman 2003).
2. An exception was found for Zimbabwe when it was studied in the mid-1990s. The existence of a relatively efficient court system there did encourage greater use. Interestingly, there were more breaches of contract noted in Zimbabwe, suggesting that the availability of enforcement through courts encouraged more adventurous lending, which led to more breaches.

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