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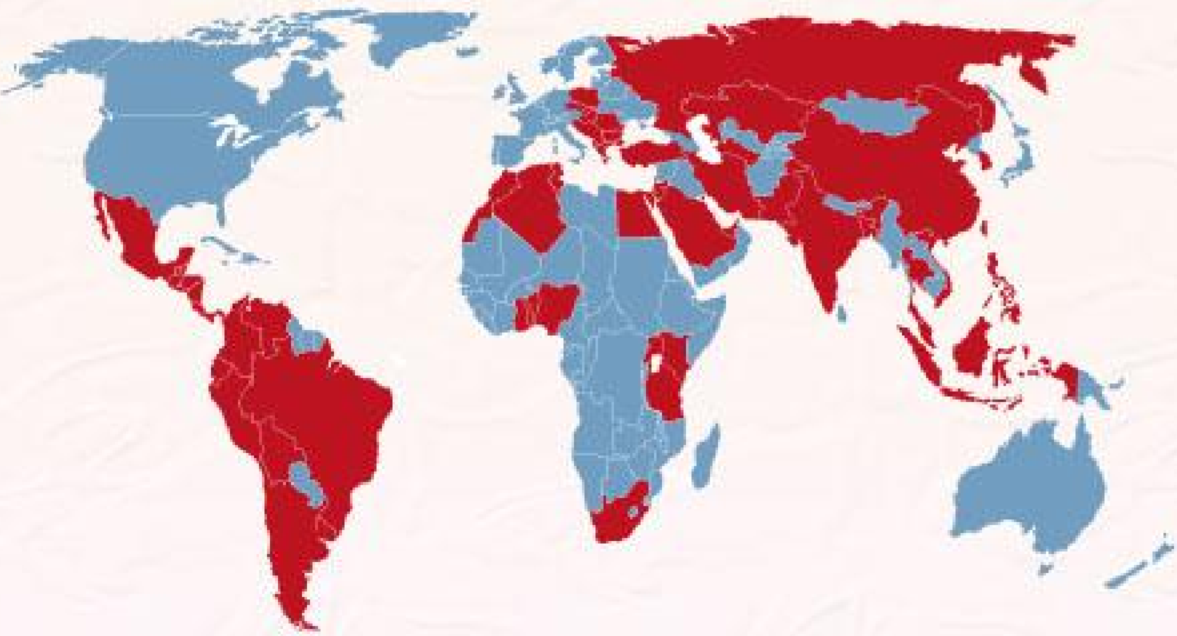

Financial Sector Challenges in Africa's Emerging Markets

Massimo Russo and Piero Ugolini

Discussion Draft

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AFRICA EMERGING MARKETS FORUM 2008

Introduction

Empirical studies have convincingly shown that there is a strong correlation between financial sector development and economic growth: countries with efficient and well functioning financial markets grow faster.

The purpose of this paper is: (a) to offer a panoramic view of the status of development of the financial sector in Africa, (b) to identify the challenges ahead, and (c) to provide some advice on how to address these challenges. [1]

The topics discussed and the issues raised are largely relevant for the entire African continent, and in particular for the group of 21 countries covered by the Africa Emerging Market Forum.[2] The paper comprises three chapters. Chapter I reviews the current situation and state of development of the financial sector. Chapter II deals with the challenges ahead, and Chapter III presents a policy agenda for the future and some recommendations for immediate consideration. Some final remarks and issues for discussions conclude the paper.

I. The State of Play

Africa continues to lag behind other regions of the world in terms of financial sector development and regional integration. No active interbank market activities or significant capital flows normally take place within the continent. In order to analyze the reasons behind this situation, it is important first to note that Africa is a very large continent with a variety of economies and financial sectors at different stages of development. In addition, per capita income is generally low and income distribution skewed.

The export sector, which is the mainstay for most African economies, comprises some of the world largest exporters in of oil (Algeria, Angola, Cameroon, Congo D R, Equatorial Guinea, Gabon, Nigeria), minerals (Botswana, Liberia, Niger, Sierra Leone, South Africa, Zambia), and primary agricultural products such as coffee (Ethiopia, Kenya, Tanzania, Uganda), cocoa (Cote d'Ivoire, Ghana), cotton (Chad, Egypt, Mali) and groundnuts (Senegal). The export of manufactures is important only in Egypt, Mauritius, Morocco, South Africa and Tunisia.

In regard to the financial sector, countries like Egypt, Morocco, and Tunisia in the North and South Africa in the South have reached a relatively high level of sophistication in terms of financial sector services. There is another group that is witnessing a steady expansion of the financial sector (Botswana, Cameroon, Ghana, Kenya, Mauritius, Namibia, Nigeria, Senegal, Tanzania, Uganda, and Zambia). The remaining countries lag considerably behind, especially those that are recovering from years of social unrest and hostilities (Angola, Chad, Congo DR, Cote d'Ivoire, Eritrea, Ethiopia, Liberia, Rwanda, and Sierra Leone). . Lastly, Zimbabwe, which used to have a solid base for strong financial sector development has gradually witnessed rapid regression for various reasons, including weak macro policies that have led to a prolonged bout of hyperinflation.

[1] The paper relies heavily on three studies: "Making Finance Work for Africa" IBRD (2007); "Sub-Saharan Africa-Financial Sector Challenges" IMF (2006); and IMF Occasional Paper 169 "Financial Sector Development in Sub-Saharan African Countries" (1998).

[2] Namely Algeria, Angola, Botswana, Cameroon, Cote d'Ivoire, Egypt, Ethiopia, Ghana, Kenya, Madagascar, Mauritania, Mauritius, Morocco, Nigeria, Senegal, Sierra Leone, South Africa, Tanzania, Togo, Tunisia, and Uganda.

Background

To understand better the unevenness of financial sector development in Africa, it may be helpful to recall briefly the history of the continent, in particular Sub-Saharan Africa (SSA). In this region, formal banking began with the establishment of "colonial banks". These were mostly interested in providing services to colonial enterprises engaged in mining and manufacturing. They were also used as captive banks to finance growing public sectors. The most important banks emerged mainly in Kenya, Nigeria, South Africa, and Zimbabwe.

Following independence in the 1960s, most colonial banks were nationalized and a number of development banks created in particular to finance the agricultural sector. Owing to the then prevailing political ideologies, government intervention and protectionism became the key policies. Banks were largely devoted to channel resources to the Government and preferential sectors .Central banks were assigned responsibility for credit allocation and economic development rather than safeguarding monetary stability. Moreover they were given very little independence in conducting monetary policy and remained subordinated to the Finance Ministry, as in the colonial period. Assessment of risk and efficiency of bank credits was not made according to the prevailing best practices and no effective banking supervision and enforcement were put in place.

In a matter of years, the banking sector collapsed in several African countries burdened by nonperforming loans, many of which were made to politically connected individuals and companies. Most development banks were closed leaving a legacy of large outstanding debts on the books of the banking sector and ultimately of the central bank and the government

Some legacy points

A few additional important points deserve to be highlighted in the history of Africa's financial sector. With the exception of the CFA monetary area, the banking sector in most countries was focused on domestic needs only and there was no vision to create regional markets in order to benefits from economies of scale and develop inter-countries exchanges. The legacy of different colonial roots (the English Common Law and the French Civil Code) that are at the basis of the legal structures in Africa, can also explain some cross-country differences in financial sector development. The main difference between the two legal systems lies on their ultimate purpose and objective. The English Common Law, which influenced the Former British colonies, wanted to protect citizens from abuses by the State. Thus, it gave flexibility to judges and facilitated trade and exchanges between private citizens and enterprises. The Civil Code, which influenced the former French, Belgian, and Portuguese colonies, tended instead to protect citizens from abuses by powerful property holders and to solidify State power over private citizens.[3]

[3] For example, the different legal frameworks have had an impact in recent years on the introduction of "purchases and repurchase agreements" (repos) used by modern central banks to manage domestic liquidity. The countries with Common Law were able to introduce repos rapidly. Those with a civil code had instead to go through elaborate legal procedures to be able to dispose of collateral in the event of default. Apparently, the introduction of credit cards has also been facilitated by the Common Law's flexibility. Similarly for bankruptcy cases, the Common Law has made it easier to dispose of assets.

Financial sector composition

The financial sector in Africa is dominated by commercial banks.Non bank financial institutions (NBFIs) and Microfinance (MFIs) are gradually growing; only a small group of countries has a stock exchange. Banks hold more than 80 percent of total financial assets, followed by insurance companies, pension funds, and other NBFIs. Interbank market transactions are very limited and largely confined to within branches of large foreign owned banks. In some countries, postal offices play an important role in collecting deposits from remote areas.

As a proxy measure of the state of development of the financial sector, bank assets as percent of GDP vary across countries in line with income levels and stage of development. In Africa they range from the high levels of South Africa (109 % in 2004 and 119% in 2006), Egypt (95%), Morocco and Tunisia (89%), Algeria (76%) to the lower levels of Ghana, Tanzania, and Uganda (27-22%) and the CFA countries (16%). (Table 1)

On the insurance side, South Africa is again the most dominant with assets of 82% of GDP. Morocco follows with about 16%, Kenya with 7%, and Senegal and Tunisia with about 4 %. For most other countries with available data, the share is only 1-2 % of GDP.

Pension funds and other NBFIs are quite important in South Africa (assets amount to about 85 % of GDP), followed by Botswana (47%), Morocco (32%), Tunisia (28%), and Kenya (26%). Of note is also Ghana with assets equivalent to some 11% of GDP.

The share of foreign-owned banks has increased in recent years. Following several banking failures of government owned banks in most SSA countries, governments have opened doors to new capital and attracted foreign banks. Only in Algeria, Eritrea, Ethiopia, and Togo the banks are still mainly government owned (Table 2). In Angola, Egypt, Morocco, and Tunisia there are both private and public banks operating Old colonial banks or their descendants have quickly returned, but noteworthy is the appearance of South African banks and some other large international banks such as Citibank.

A comparison of the financial market structure with other regions shows that South Africa and some North African countries are comparable to other emerging markets while SSA, in general lags considerably behind (table 3).

TABLE 1-- Financial Sector Structure of Selected African Countries, 2004

	Bank Assets (as percent of GDP)	**Insurance Companies** (as percent of GDP)	**Pension Funds** (as percent of GDP)	**Other NBFIs** (as percent of GDP)
SUB-SAHARA				
Angola	24.1	…	…	…
Botswana	37.0	1.5	16.1	31.7
Cameroon	18.7	…	…	…
Côte d'Ivoire	15.0	…	…	…
Ethiopia	84.3	1.4	1.4	2.9
Ghana	27.3	1.1	8.1	3.2
Kenya	38.5	6.8	13.2	12.6
Madagascar	24.5	…	…	…
Mauritius	97.6	…	…	5.2
Nigeria	45.0	…	…	…
Senegal	37.3	3.7	…	1.1
Sierra Leone	…	…	…	…
South Africa (2006)	119.0	82.0	62.0	23.0
Tanzania	23.0	1.0	4.0	…
Togo	18.0	…	…	…
Uganda	22.1	0.8	2.5	0.3
Oil-exporting countries	33.6	…	…	…
CFA countries	16.1	…	…	…
North Africa				
Algeria	75.7	2.2	…	3.6
Egypt	95.3	2.2	1.9	0.6
Mauritania	34.0	2.0	…	2.1
Morocco	89.0	15.7	14.2	18.3
Tunisia	89.9	4.3	8.3	19.3

Source: World Bank data and IMF, *International Financial Statistics*

Table 2 -- Bank Ownership in Africa

Mainly Government	Mainly Foreign	Mainly domestic private	Foreign and Government
Algeria	Botswana	Benin	Angola
Eritrea	Cape Verde	Mali	Burundi
Ethiopia	Central African Republic	Mauritania	Egypt
Togo	Chad	Mauritius	Gabon
	Cote d'Ivoire	Morocco	Ghana
	Equatorial Guinea	Nigeria	Kenya
	The Gambia	Rwanda	Rwanda
	Guinea Bissau	Somalia	Senegal
	Guinea	South Africa	Tunisia
	Lesotho	Sudan	
	Liberia	Zimbabwe	
	Madagascar		
	Malawi		
	Mozambique		
	Namibia		
	Niger		
	Seychelles		
	Swaziland		
	Tanzania		
	Uganda		
	Zambia		

Sources: World Bank and IMF data.

Table 3 -- Maghreb Countries: Financial System Structure, 2004
(In percent of total assets)

	Commercial banks			Specialized banks	Insurance companies	Pension funds	Other MFIs
	State-owned	Private	Total				
Algeria	83.4	9.4	92.8	…	2.8	…	4.4
Libya	…	…	…	…	…	…	…
Mauritania	…	…	88.2	…	5.0	…	6.8
Morocco	35.3	24.4	59.7	11.0	10.6	15.6	3.1
Tunisia	30.6	39.1	69.7	3.0	3.4	6.5	17.4
Korea	6.5	43.2	49.7	22.0	18.2	…	10.1
Mexico	--	50.3	50.3	12.6	7.5	12.7	16.9
Poland	14.3	52.0	66.3	…	10.5	10.3	12.9
Portugal	17.6	54.7	72.3	6.8	9.0	3.8	8.1
Turkey	18.3	39.6	57.9	1.8	0.8	0.6	38.9

Sources: National authorities; and Bank-Fund staff estimates.

Progress made

By the late 1980s and early 1990s, faced with deteriorating domestic economies and an unfavorable world environment, African countries embarked upon a policy of adjusting their economies and dismantling controls and restrictions that had become institutionalized. Most of this adjustment was generally implemented in the context of IMF- and World Bank- supported programs. Indeed by end-1996, 21 countries were implementing these programs. Their relative success is evidenced by a sharp reduction of inflation and resumption of steady growth.

The reforms made encompassed all sectors of the economy: fiscal discipline and aggregate demand control, trade and current and capital accounts liberalization, and the lifting of price controls on most consumer goods. In the financial sector, the authorities undertook sweeping reforms to revitalize and place the banking system on sound ground. Interest rates were liberalized and administrative credit allocation eliminated. Laws were amended to grant more autonomy to central banks and enable them to conduct monetary policy with indirect instruments

Countries also started paying more attention to restructuring commercial banks in order to restore their solvency and viability. Under Basel I, African authorities began building gradually a supervisory framework. Together with prudential regulations, initial auditing and accounting standards were introduced. Primary markets for government securities started flourishing in some countries, replacing the inflationary direct central bank financing of the government. This is also the period when the authorities begun realizing the importance of globalization and preparing for integration in the world economy.

Many African countries have by now made significant strides in adjusting their economies, fostering growth and moving toward regional integration. The fourteen countries belonging to the CFA franc area have even established two fully fledged monetary unions. Several countries have thus laid a good foundation over which to build a modern and efficient financial sector. However, considerable work still lies ahead

Financial depth, competition and efficiency

Despite large differences in the relative size and level of development of African economies, there are similarities in issues related to financial sector development and efficiency A recent study by the World Bank (Making Finance Work for Africa) has provided a comprehensive assessment of the financial sector in SSA compared with other world regions and identified the areas that need improvement. The broad conclusion is that, on average, African financial sectors perform well below those of other regions and has a large potential for improvement.

The multifaceted analysis is based on depth, competition and efficiency, non-bank finance, and access to financial services. According to this study, Africa’s financial sector is shallow and adversely affected by factors such as low income, large offshore deposits, weak credit expansion and lending opportunities, high banking spreads and excessive overhead costs and profits. State interference continues to be a problem in many countries.

Only one third of the countries have organized securities markets. Besides South Africa, only a few stock exchanges in the continent have reached a significant level of capitalization. The performance of insurance companies, especially in the life sector, is mixed. For some countries (South Africa, and to a lesser extent Kenya, Morocco, and Tunisia) the insurance sector represent a strong potential for financial market development while in most other countries it remains at an embryonic stage.

Depth

In terms of aggregate banking depth -which is normally measured as deposit resources mobilized and credit extended relative to GDP - Africa lags behind other regions (Table 4). The ratio of liquid liabilities to GDP averages 32 percent in Africa compared with 49 percent in East Asia 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 East Asia and 107 percent in high income countries. Within Africa, higher-income countries have deeper financial systems (Egypt, Mauritius, Morocco, South Africa, and Tunisia). According to World Bank data, in SSA some 47 percent of the population in Botswana and South Africa has a formal account with a bank. This compares with Mauritius (14%), Kenya and Nigeria (10%), Uganda (6%), Ghana and Tanzania (5%). African oil exporting countries (7%) and CFA countries (4%).

Chart 1 shows the evolution of the ratio of private sector credit to GDP as a proxy for financial activities by banks and near-bank intermediaries during the period 1993-2005 in South Africa, North Africa and SSA. The level of South Africa is comparable to that in OECD countries and rising. The same picture emerges for North Africa when compared to some other Emerging Markets in other regions of the world. The median value for SSA remains very low and stationary,

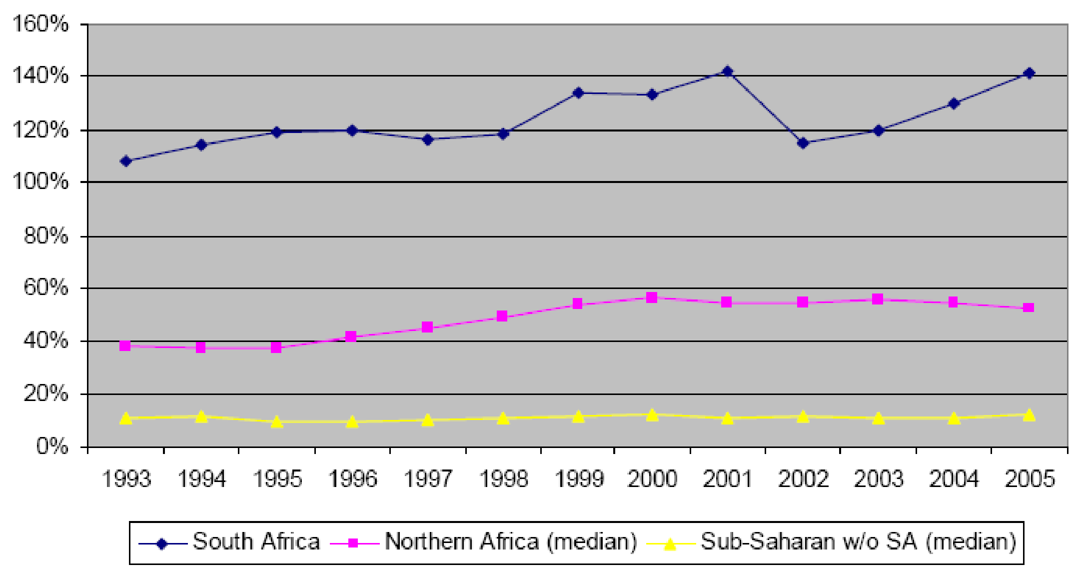
TABLE 4 -- Banks Depth in Selected African Countries, 2004

	Bank credit to private sector (as percent of GDP)	**Bank credit to central government** (as percent of GDP)	**Demand and Savings Deposits** (as percent of GDP	**M2** (as percent of GDP)
SUB-SAHARA				
Angola	4.3	1.9	12.0	15.0
Botswana	17.7	…	28.0	30.2
Cameroon	8.8	1.7	13.0	17.3
Côte d’Ivoire	13.8	3.6	15.0	23.6
Ethiopia	21.0	12.7	34.0	57.4
Ghana	11.6	8.9	22.0	32.1
Kenya	23.5	10.1	33.0	39.0
Madagascar	8.5	4.0	17.0	24.4
Mauritius	56.4	21.6	124.0	89.7
Nigeria	13.7	5.0	0.9	23.6
Senegal	20.3	1.7	25.0	35.5
Sierra Leone	3.9	4.8	11.0	19.1
South Africa	79.9	6.8	53.0	66.5
Tanzania	7.5	2.6	18.0	23.1
Togo	15.9	1.4	21.0	28.6

Uganda	5.9	6.8	15.0	20.5
Oil-exporting countries	11.1	3.5	7.1	20.0
CFA countries	11.8	1.5	3.9	20.4
North Africa				
Algeria	25.1	…	43.0	61.1
Egypt	52.0	26.0	84.0	91.0
Morocco	50.3	17.0	75.0	81.0
Tunisia	66.0	6.0	47.0	57.0
France	98.0	22.0	70.0	….
U.K.	153.0	2.0	118.0	...
Poland	26.0	11.0	34.0	24.0
Korea	89.0	5.0	68.0	62.0
Malaysia	118.0	8.0	124.0	119.0
Philippines	30.0	16.0	49.0	27.0

Sources: World Bank data and IMF, ***International Financial Statistics***

Chart 1-- Private Credit/ GDP in Africa
(In percent)



Source: World Development Indicators, World Bank

Reproduced from Philip M. Hildebrand (2007).

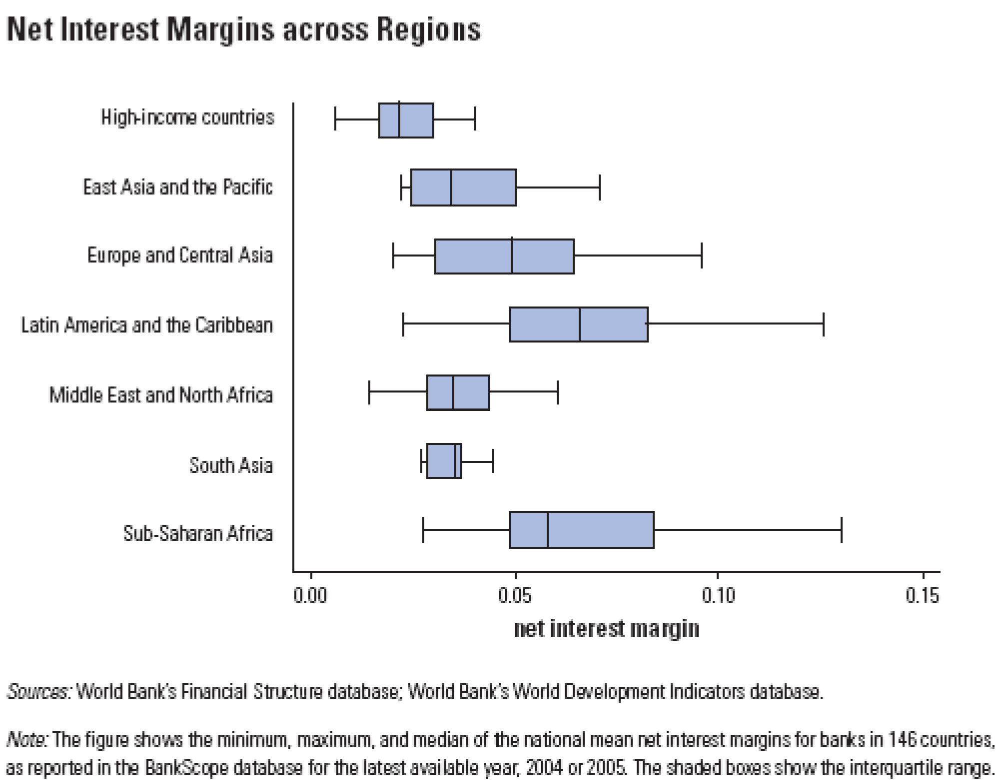
Competition, Efficiency and Interest Rates

Banks' performance in Africa is characterized by high interest rates on loans, large spreads over deposit rates and high rates of return for those banks with solid performing assets. Following interest rate liberalization, wholesale interest rates increased considerably in the 1990s. The high interest rates stem from a combination of high risk, costs inefficiencies, and lack of competition. Also, in many countries, government owned banks are burdened by a sizable amount of non-performing loans. This, together with other macroeconomic factors linked to uncertainty and instability, tends to push up banks' interest rates.

Banks' spreads - the difference between average deposit and average lending rates - are large in African countries and, as a result, banks are in general quite profitable. While the spread is partly utilized to cover operating costs, the high spreads noticed in African countries seem to result from lack of competition, serious obstacles to new entry, collusion, market segmentation and a significant country risk. Clearly, the experience varies from country to country depending on the size and number of banks and the pool of potential customers. Where there is a large presence of foreign banks, normally these tend to concentrate on the large international clientele with lower risk of default, while domestic banks have to draw clients from local enterprises, which raise considerably the risk of default for them.

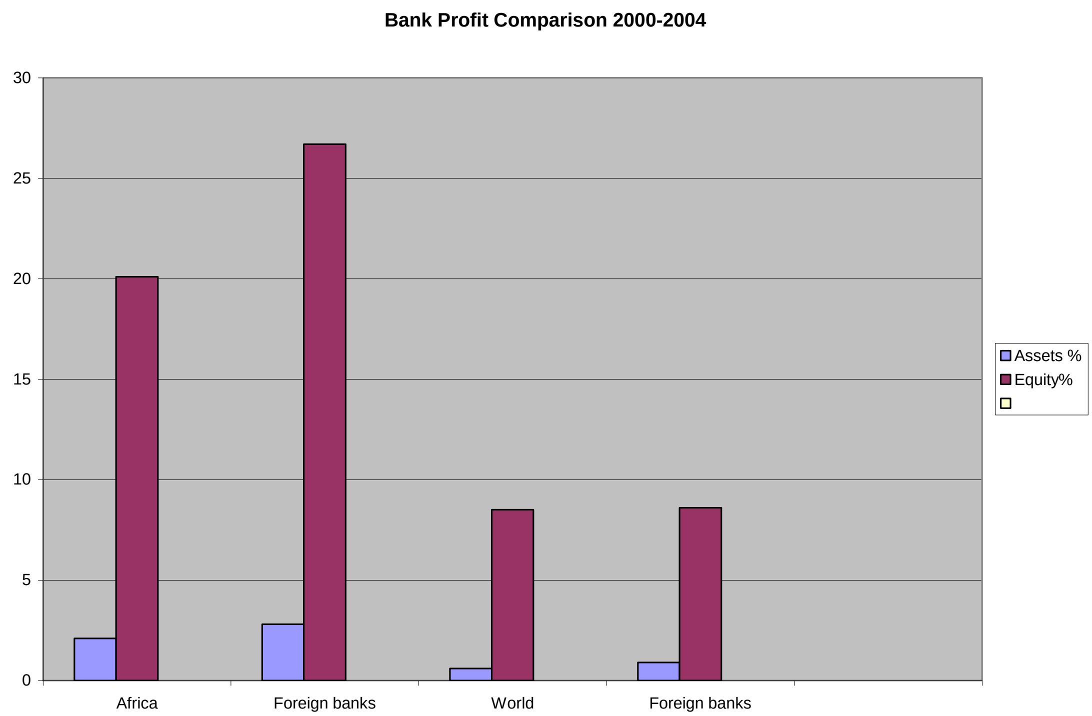
Chart 2 compares net interest margins across regions. During the period 2000-2004, the net interest margin in African banks was, on average, 800 basis points compared with 480 basis points for the rest of the world (however, banks in Latin America show a similar pattern.) On overall profitability, African banks perform well when compared to other regions. Returns on total assets and on equity, were roughly three times larger than in the rest of the world (Chart 3).

Chart 2



Reproduced from World Bank (2007)

Chart 3



Source: World Bank "Making Finance Work for Africa
Reproduced from World Bank (2007)

Bank operating costs are also an important factor in setting interest rates. A study conducted for 75 countries across the world indicated that the quality of the judicial system (property rights protection) is one of the main components of banks' costs. Weaker property rights force banks to invest more resources in credit appraisal and legal fees. Weak property rights and poor governance are certainly one of the major weaknesses in Africa. Operating costs are also affected by banks size and economies of scale. The average African bank has estimated total assets of only about US$ 80 million compared with US$ 334 million for the rest of the world. In addition, the banking system is highly concentrated. Normally two or three banks hold the bulk of total assets. A study of 22 African countries shows that the market share of the top three banks in Africa averages more than 70 percent of total assets compared with 60 percent in the rest of the world. While concentration is not necessarily an indication of lack of competition, there are systemic risks linked to high concentration in the event that one bank fails or is in difficulty.[4]

Finally, macroeconomic stability and inflation are important factors that have played a role in Africa in the development of the financial sector. Macro stability is closely tied to political stability. In SSA over the last 50 years, all but nine countries have experienced internal or external conflicts. In some countries, like Liberia and Sierra Leone, large efforts and numerous technical assistance have been devoted to, and lost in building and rebuilding a financial sector. As a result of this regional instability, interest rates are high since the country risk plays an important role in

[4] Making Finance Work for Africa, World Bank (2007) pp. 22-42

pricing banks' services. Lastly, following price liberalization, volatility in international markets (largely oil) and government spending, inflation in Africa has averaged around 36 percent versus 20 percent in the rest of the world over the period 2000-2004. This, as normally occurs during inflationary periods, boosts interest margins.4

Excess liquidity

The African banking sector is generally very liquid. The excess liquidity stems from several sources. On the one hand, excessive government spending and foreign inflows, in particular from oil export receipts and donors' assistance, have injected considerable liquidity in the system. On the other hand, as indicated above, the lack of good investment opportunities and reputable clients as well as a judicial system that does not give full right protections to creditors, has adversely affected credit extension. Another factor of relevance is the high borrowing costs in Africa, which encourage international firms and others to borrow abroad. Finally, the lack of monetary instruments and resources to absorb part of the liquidity by the central bank or via government securities also play an important role.

Regulatory framework

Considerable progress has been made in building supervisory authorities in Africa. Under the Basel I and the Core Principles of Effective Supervision, all countries have realized the importance of soundness and stability of the financial sector. Prudential regulations and minimum capital standards have been introduced and the legal framework for the financial sector has been amended in line with best practices and international standards in virtually all African countries.

The outcome, however, in enforcing these regulations and standards has been somewhat mixed. Regulatory agencies, central banks or financial services, are not totally independent from the Government. Liquidating a bank that is largely or partly owned by the Government is still very problematic and recapitalization of these banks takes considerable time and resources. Enforcement of some regulations such as credit concentration is also a major problem considering that banks are very limited in extending credit beyond the core group of clients. As a result banks in Africa are heavily exposed to credit risk. Finally, while several countries (recently Nigeria) have restructured their banking sector and consolidated non-performing loans, there are still banks (largely government owned) that carry large non-performing assets in their portfolio.

Payments systems

During the last few years, the African continent has made significant progress in joining SWIFT's global community. On the basis of data collected in 2005 by SADC experts, some 720 users in 50 African countries – virtually the entire continent – were connected to SWIFT and sent approximately 55 million messages with an annual growth rate of about 15 percent. The last few years have seen these countries rapidly leveraging their connection to SWIFT by setting up real time gross settlement (RTGS) systems based on SWIFT. About two thirds of African countries either have or are putting RTGS systems in place, making their payments systems safer, stronger, and more secure.

Notwithstanding the use of SWIFT, in only a few African countries do the payments systems meet international standards. Because of a largely cash economy, the use of checks and credit/debit cards is progressing very slowly, and, in some cases, large transfers have to be approved by the authorities. Also the judicial system to protect cards issuers is weak and does not encourage their expansion. On a regional basis, there are no active payments systems that link several countries. It is, however, worthwhile recalling South African Multiple Option Settlement (SAMOS), that offers a range of settlement options to the banking industry in South Africa with the ultimate objective of realizing a cross-border payment and settlement system for the 14 members of SADC (Southern African Development Community).

Shallow interbank market

Interbank market activities in Africa are very limited. Most of these activities are confined to trade between foreign/international banks. It is interesting to note that even in the CFA monetary unions interbank activities are very limited. The main reasons for the shallowness of the interbank market lie with the excess liquidity in the financial sector and with the lack of confidence in lending between banks on a non-collateralized basis. Lack of an efficient payment system and communications are also an important factor. Finally, in some countries the availability of the central bank in providing access to resources does not encourage banks to deal with each other.

Non bank finance

As shown in Table 5, several countries have created a stock exchange with the objective of boosting commercial activities and fostering a capital market. However, overall the outcome has not been very positive. Even in the case of South Africa with US$600 billion of capitalization - the fourth largest market in the world for an emerging economy - the size of the market is not large enough to retain the listing of the largest South African companies. In the case of Egypt with 441 companies listed the value traded as percent of GDP was only 7.5 percent and the turnover 17.1 percent in 2005. For most of the countries, the small number of listed firms and lack of turnover make the stock exchanges in Africa unprofitable. The lack of turnover and liquidity also creates a vicious circle insofar as the weak demand and activities do not encourage and justify investments in technology and modernization. Clearly, the low level of economic activity in some countries is a major factor. But, in addition, the lack of transparence of the accounts of the listed companies - most of which are not rated by agencies, - the uncertainty over the supervision of the exchanges and the vetting of the listings are all factors not conducive to encouraging active investments

TABLE 5 -- Selected Stock Exchanges in Africa (2005)

	Number of listed firms	Market capital (as percent of GDP)	Value traded (as percent of GDP)	Turnover (in percent)
SUB-SAHARA				
Botswana	25	27.2	0.6	2.1
Côte d'Ivoire(BRVM)	39	12.3	0.3	2.5
Ghana	30	23.7	0.8	3.2
Kenya	47	26.1	2.1	7.9
Mauritius	41	36.0	1.6	4.4
Nigeria	207	5.0	9.6	13.9
South Africa	403	170.5	76.5	44.9
Tanzania	6	6.2	0.2	2.5
Uganda	5	1.4	0.0	0.2
North Africa				
Egypt	441	74	7.5	17.1
Morocco	54	55.1	32.0	…
Tunisia	45	10.0	4.0	…

Sources: IMF, FSAP and Article IV consultation reports

Insurance, Pension, and Collective Investment

Insurance penetration is low across Africa except for a few countries (South Africa in particular). The importance of developing this sector is fully understood by the authorities since insurance institutions are potentially large suppliers of investment funds. Obstacles related to income levels and weak contractual systems are a factor as well as the lack of a strong supervisory framework. In Africa, most of the insurance funds are invested in government securities, real estate, and bank deposits; very little is invested in equities and corporate bonds.

Access to financial services

Access to financial services is, in general, very limited in Africa, especially in the SSA region. Available World Bank data indicate that fewer than 20 percent of African adults have an account with a bank or a micro-finance institution. When African countries are compared with other regions, the difference is striking. For example, Kenya, which has one of the most developed financial sectors in SSA numbers about 70 deposit accounts per 1,000 people while for instance, Malaysia records some 1,250 accounts. On the loans side, Uganda accounts for about 6 loans per 1,000 people versus 41 for Armenia in Eastern Europe.

There are several reasons for this lack of access to formal financial services, In addition to political instability; fiscal indiscipline and the poor reputation of public institutions are important factors.

History has shown that developing financial sectors in countries that have been affected by social unrest and disruptions takes considerable time and resources.

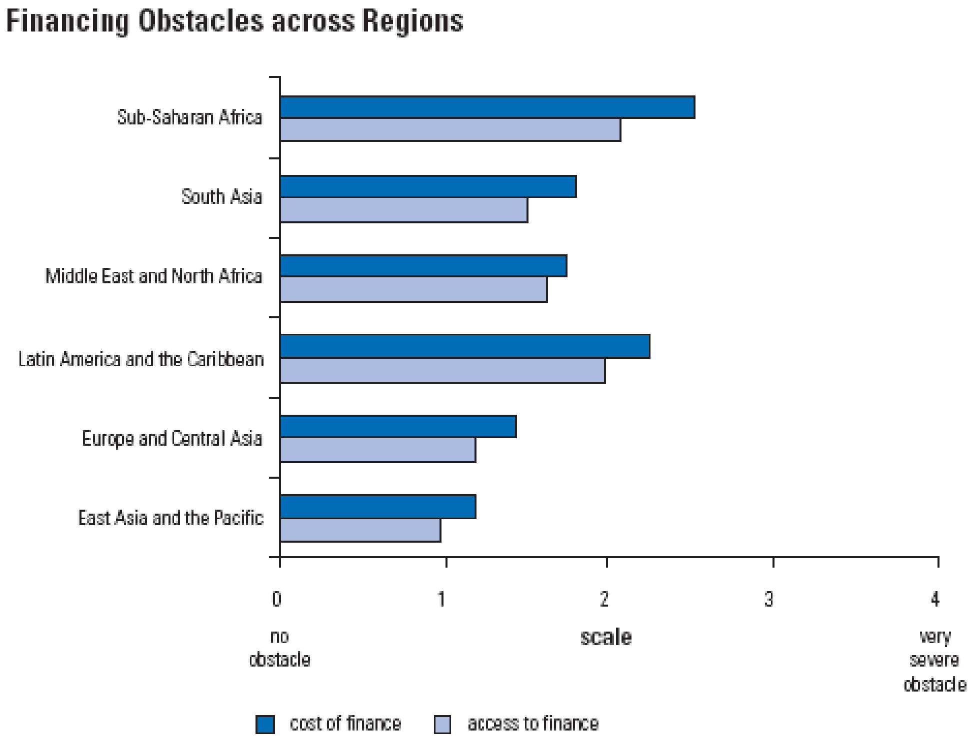
From the banking side, there are a few banks that are prepared to invest in remote areas. Rigidities in opening and closing branches also represent an obstacle, as is transportation and communication. Therefore collecting savings and demand deposits is very problematic. In addition, banks require minimum deposits and balances, which are too high for the majority of the population. According to World Bank estimates, 54% of the population in Cameroon, 81% in Kenya, 94% in Malawi, 89% in Sierra Leone, and 93% in Uganda cannot afford the bank fees to open a checking account.

Lastly, in many countries, the authorities still fix minimum rates for savings and other deposits and maximum lending rates. In some cases, this may force banks to refuse deposits. One recent example is the case of Cameroon. As a result of improved fiscal discipline and good balance of payments outcomes, the country is experiencing excess liquidity. The monetary authorities (BEAC) fix minimum rates for savings deposits and maximum lending rates. Given the excess liquidity situation and the lack of good loan opportunities, banks are reluctant to accept savings deposits.

On the loan side, the low access to the formal sector is even more acute. Several barriers are placed between the banks and the customers. There are two main stumbling blocks: (1) poor information and accounting practices by the borrowers and (2) a weak judicial system to protect the legal rights of creditors. On the first point, there is no uniformity in accounting standards in the African continent. Also, there are too few certified public accountants and rating agencies. This complicates considerably the task of the financial sector in extending credit beyond the small core of reputable clients. The lack of a judicial system capable of protecting creditors and borrowers is a chronic problem in Africa as is in some other parts of the world (Latin America for instance). Magistrates are often not competent to handle financial sector issues and the court cases can be very lengthy. Some questions on the ethical behavior of the magistrates are also a factor. In many countries, bankers consider the judicial system an even more important problem in credit decisions than the disclosure of accounts.

In addition to the main points presented above, there are other obstacles to financial access. In many countries, government financing requirements are still crowding out credit expansion to the private sector. This creates a conflict of interest because the government is a share-holder of the banks. In addition, the financial sector cannot rely on commercial and personal credit registries, which are not updated and hamper the credit information and the use of collateral. Similarly for land registries. Overall, the cost of finance in Africa is one of the highest among all regions while access is close to the experience of Latin America and the Caribbean (Chart 4).

Chart 4



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.

Reproduced from World Bank (2007)

Microfinance

The problems related to access to bank finance have fostered the growth of micro-finance in the African continent and in SSA in particular. To a large extent, microfinance institutions (MFIs) have been successful in servicing a segment of the African population. Savings collections at low cost together with small loans requiring minimum information have helped the MFIs to flourish. Data on MFIs are hard to collect because most of the sector is “informal” even though there are large MFIs that are regularly supervised by the authorities (e.g. in the CFA area). Information presented in Table 6 gives a rough indication of the MFIs in SSA. In Tunisia, one large MFI had assets accounting for 0.5 % of GDP in 2004.

Table 6 -- Sub-Saharan Africa: Microfinance Sector Indicators				
	People Served (percent of total population)	**Size (Assets) Percent of commercial bank assets**	**Size (Assets) Percent of GDP**	**Nonperforming Loans** (percent of total loans, weighted by assets)
Sub-Saharan Africa	2.7	5.2	1.3	10.2
WAEMU	5.1	6.1	1.4	2.6
CEMAC	0.9	2.2	0.3	9.9
East Africa Community	6.8	12.3	4.1	14.2
Non-CFA	2.3	5.4	1.4	11.9

Source: IMF Sub-Saharan: Financial Sector Challenges

II. The Challenge of Enhancing the Financial Sector in Africa

Chapter I has summarized the current status of financial sector development in Africa. The main conclusion was that while development is uneven across the continent, many issues are common to a large number of countries. In addition to the relative weak institutional underpinnings discussed above, the small size of many economies limits their ability to sustain a modern financial sector.

South Africa together with Egypt, Morocco, and Tunisia stand out for having the most developed financial sector. South Africa, in particular, could be a relevant benchmark for other African countries in terms of financial sector structure and compliance with international standards and best practices. Some large SSA countries, such as Angola, Cameroon, Cote d'Ivoire, Kenya, and Nigeria have a clear potential for satisfactory development of their domestic financial sectors but the smaller economies will most probably need to adopt a regional approach. Oil exporting countries such as Congo DR, Equatorial Guinea, and Gabon have a large potential in terms of financial resources but in our view they too will have to consider integrating with other countries in order to develop a viable and modern financial sector and capital market.

Expanding the market via regional integration provides probably the best solution to many of the problems presented above. However in order to expand the financial sector horizon, it is essential that African countries first take, at the domestic level, the steps required to strengthen and harmonize their financial structures. This will both facilitate regional integration and make the domestic financial sector more resilient to shocks and more attractive to capital inflows and investments. As the experience with the European Union suggests regional financial integration must be preceded by integrating the markets for goods and services and must be conceived as an evolutionary process in terms of both its depth and geographical coverage. Only those countries that have achieved sufficient robustness and harmonization of their domestic financial sectors would proceed with integration leaving the door open to new participants if and when they are ready.

Actions to be taken at the single country level - where needed - include:

- Conducting prudent fiscal and monetary policies geared towards sustainable growth, price stability and reduction of poverty.
- Adopting financial sector legislation aimed at providing independence to the monetary authorities and fostering the use of indirect monetary instruments in the conduct of monetary policies.
- Implementing financial sector legislation that promotes access to financial services and establishes a level playing field for financial institutions.
- Modernizing the judicial system by establishing special courts for financial sector matters and training magistrates to protect and enforce creditors' rights
- Adopting common international standards and best practices[5]. Transparency in policy implementation is also important for establishing a clear channel of communication among the financial market participants.
- Expanding the modern financial sector by gradually integrating some aspects of the "informal" MFIs into the "formal" banking sector.
- Privatizing banks. Government's ownership should gradually diminish in order to eliminate undue political influence on financial sector's decisions and allow market conditions and independent risk evaluations to determine credit allocation and the prices for financial services.
- Encouraging the development of pension funds and other institutional investors as steady providers of long-term financing As the South Africa's experience shows, pension funds, collective investments, and insurance companies represent an important source of long-term financing and help the development of a capital market. As these institutions like to match the maturity length of their liabilities with assets, they are very active in investing in medium and long-term securities. In Africa, most government securities are of short maturity. While the main objective is to extend the maturity of the debt, the lack of long-term financing is also one of the main impediments to developing a yield curve for benchmarking.
- Adopting the proper strategy for developing securities markets. Normally, government securities are the first instrument used to further the development of other securities. In this endeavor, the authorities should follow best practices, for instance those recommended in the IMF/World Bank "Guidelines for Public Debt management." Some of the key recommendations are transparency and coordination between the government and the monetary authorities in developing a realistic cash flow and liquidity management strategy to ensure the marketing of the securities and the further development of secondary market activities. Currently, in almost all African countries there is no secondary market for securities.
- Developing a collateralized interbank market. With the establishment of appropriate securities markets, it would also be possible to develop a fully collateralized interbank market. The introduction of a book-entry system and de-materialization of securities are

[5] The most relevant are: Basel Core Principles for Effective Banking Supervision, IAIS –Insurance Supervision Core Principles, IOSCO Objectives and Principles of Securities Regulation, CPSS Core Principles for Systemically Important Payment Systems, and CPSS/IOSCO Recommendations for Securities Settlement System. There are also: International Accounting Standards, Transparency Codes, Corporate Governance Principles, and Guidelines for Public Debt Management

essential for such a strategy. A collateralized interbank market can attenuate the credit risk related to the lack of information on the status of the borrower. As indicated earlier, countries that follow the common law may find this easier to implement. [6]

While meeting these challenges domestically, countries would benefit from adopting a regional perspective in designing the specific measures to be adopted. To this end the following actions could be considered:

- Creating regional supervisory authorities. A regional authority would reduce costs by sharing scarce professional resources and will be less constrained by domestic political pressures in the event of banking difficulties, in particular when government owned banks are involved.[7]
- Allowing capital to move across countries in the region to ensure that resources move freely and financial transfers are not hampered by regulations or delayed by lengthy approval procedures.
- Consolidating domestic stock exchanges into regional exchanges. Stock exchanges need large markets to develop and become viable and efficient.
- Modernizing the payments systems with a view to facilitating transactions across countries.
- Introducing new technology to facilitate communication and exchanges of information.
- Considering the possibility of ultimately creating or joining a monetary union.

There are at present in Africa many fora and institutions that aim at fostering regional cooperation and integration which could help in this endeavor (see Appendix 1).

III. An Agenda for Action

Meeting these challenges requires detailed plans for action and careful sequencing tailored to the circumstances of each country and regional grouping. The IMF/World Bank FSAPs have been providing assessments of financial sector structures in Africa. Table 7 shows that except for Angola, Ethiopia, and Togo all countries covered by the Forum have been assessed and a series of recommendations to strengthen and develop their financial sector published. These recommendations are summarized below.

In the short- to medium term, the main objective is to strengthen and harmonize the structure of financial sectors with a view to facilitating cross countries transactions and, ultimately, regional integration. As the FSAPs reports emphasize, the most important actions are maintenance of economic stability and compliance with international standards. In addition governments are encouraged to proceed with recapitalization of banks, disposal of non-performing loans, improved supervision and implementation of regulations, transparence in publishing fees and costs and reduced government interference in setting interest rates. To enhance competition, reduce costs, and better exploit economies of scale, in most countries banks' consolidation appears also necessary.

[6] However the recent experience with subprime loans in the USA indicates the need for caution in this area.
[7] Regional cooperation also offers economies of scale in other areas such as banking supervision and training in legal and accounting procedures.

Table 7 -- FSAP and FSAP Updates in Selected African Countries

	FSAP	FSAP Published	FSAP Update	FSAP Update Published
Algeria	yes	yes	ongoing	...
Angola 1/	no	...	...	...
Botswana	yes	no	...	...
Cameroon	ongoing	...	...	...
Cote d'Ivoire 2/	ongoing	...	...	...
Egypt	yes	no	yes	no
Ethiopia	no	...	...	...
Ghana	yes	no	yes	yes
Kenya	yes	no	…	…
Madagascar	yes	yes	...	...
Mauritania	yes	no	…	…
Mauritius	yes	yes	yes	no
Morocco	yes	yes	ongoing	...
Nigeria	yes	no	no	...
Senegal	yes	yes	yes	yes
Sierra Leone	yes	no	no	...
S. Africa	yes	no	yes	no
Tanzania	yes	yes	no	...
Togo	no	...	...	...
Tunisia	yes	yes	yes	yes
Uganda	yes	yes	yes	no

Source : IMF

1/ A formal request received.

2/ Initial FSAP postponed due to a civil war. A new request received from the authorities recently.

Improved accounting standards and information by credit bureaus would be needed to increase access to credit by the private sector. Changes in the judicial system and the creation of specialized courts to deal with issues related to financial sector matters, disposal of collateral, and creditors' rights would reduce bank costs.

More emphasis has to be placed on the modernization of payments systems in order to facilitate financial transactions and, ultimately, regional integration. As indicated above, SWIFT is now adopted in most African countries. Many have moved to the next step of implementing an RTGS system to reduce settlement risk and ensure finality of payments. A sound payments system leads to confidence in the economic and financial systems and encourages foreign investments.

In the longer run, the objective of regional integration can be achieved once a full harmonization of standards and structures has taken place. The benefits of such integration are a direct response to the shortcomings highlighted in Section I. The expansion of the market will increase both depth and competition in the banking sector. Also, it should encourage bank consolidations and the resulting larger economies of scale help reduce costs and charges and improve access. As already noted, African countries have established a number of regional organizations to realize these aspirations. These groupings in many cases already call for integration of goods and financial markets. One task for the future would be further to enhance progress and cooperation by revamping or accelerating reforms and innovations to achieve the objectives already laid out by the existing regional groups

When and where feasible the establishment of fully fledged monetary unions could be envisaged as an ultimate target. However, monetary unions by themselves need not ensure the full integration of financial markets as the experience with the CFA franc area has shown. They could however attenuate the impact of political shocks - which in Africa are not uncommon, as has been recently the case of Côte d'Ivoire.

IV. Conclusions and Issues for Discussion

The main message from this paper is that while progress has been made in recent years to provide a solid base to the financial sector, much work remains to be done to realize the potential for financial sector growth in Africa's emerging markets. An important task will be to determine in each instance the appropriate sequencing of the needed reforms.

The paper has attempted to spell out an agenda for the further development of the financial sector in Africa. Since progress has been uneven some countries are more advanced than others. However, even in the case of countries at a higher level of development, it will be important to expand their financial markets. The authors believe that regional integration is probably the best answer to increase efficiency, depth, and access to financial services in Africa. To this end, the authorities and the other financial sector participants must act jointly with a view of making the domestic financial sector more efficient and sound while enhancing cooperation with neighboring countries to lay the foundation for regional integrated markets.

The study published by the IMF on the Maghreb and summarized in appendix 2 is probably one of the best examples of this strategy. It recommends detailed measures – and their sequencing - to make the financial sector of members more sound and efficient. Only by doing this first financial integration can take place. Convergence in fiscal deficits and rate of inflation, exchange arrangements, payments systems, prudential regulations, international accounting and audit standards, transparence, appropriate legal frameworks with competent magistrates, and strong supervisory authorities are all deemed essential for successful regional integration.

The IMF, the World Bank and more recently the African Development Bank, have undertaken an important task in this area by providing comprehensive assessments of soundness, stability, resilience, and of developmental issues in the FSAP documents. It will be important now to consider implementing these recommendations in order to achieve the combined objective of financial sector development and economic growth both at the national and regional level.

Do participant in the Forum share these conclusions? In particular they may want to discuss the following questions:

1) Granted that countries situations differ, which in their view are the most urgent challenges and in which country? Is South Africa a good benchmark for the rest of SSA?
2) What role could the private sector, especially large international banks, play?
3) Do they share the view - strongly supported in the paper – that regional integration would greatly facilitate meeting these challenges and provide an appropriate solution to the problems of market size, institutional development and cost sharing?
4) Should trade integration necessarily precede financial integration as has been the case for the European Union?
5) As in the case of the EU, should regional integration start with small groups of countries at a similar state of financial development and progressively extend its geographical coverage as other countries ready themselves to join?

Appendix 1: List of Main Regional Organizations in Africa

East Africa Community (EAC)

The EAC is the regional intergovernmental organization covering five countries (Burundi, Kenya, Rwanda, Tanzania, and Uganda). The original treaty for the establishment of the EAC was signed in 1999 by Kenya, Tanzania, and Uganda. Burundi and Rwanda acceded to the EAC Treaty in July 2007.
The EAC aims at widening and deepening cooperation among the Partner States in, among others, political, economic and social fields for their mutual benefits. The EAC members established a Customs Union in 2005 and are working towards the establishment of a Common Market by 2010 and Monetary Union by 2012.

Economic Community of West African States (ECOWAS)

The ECOWAS was created in 1975 in Lagos. ECOWAS was established to promote cooperation and integration in order to create an economic and monetary union for promoting growth in West Africa. Fifteen countries are members of the Community and some of them are also members of the West African Monetary Union (Benin, Burkina Faso, Cape Verde, Cote d'Ivoire, The Gambia, Ghana, Guinea, Guinea-Bissau, Liberia, Mali, Niger, Nigeria, Senegal, Sierra Leone, and Togo).

West African Economic and Monetary Union (WAEMU) and Central Africa Economic and Monetary Communion (CAEMC)

In the 1960s, two regions in West Africa -WAEMU and Central Africa -CAEMC cooperated to set up two monetary unions with the Franc CFA tied to the French Franc. Today, the Franc CFA is lined to the Euro, and the central banks of these two regional organizations operate in close cooperation. The countries of these regions have worked together to reform their payment systems and to set up RTGS systems. The two regional central banks are the BCEAO and BEAC, respectively. (BCEAO – Central Bank of West African States: Benin, Burkina Faso, Guinea Bissau, Cote d'Ivoire, Mali, Niger, Senegal, and Togo. BEAC – Central Bank of Central African States: Cameroon, Central African Republic, Chad, Congo Brazzaville, Equatorial Guinea, and Gabon)

A regional FSAP was conducted in 2006 for the CAEMC region and the report is published in the IMF/World Bank web-sites. A regional FSAP for the WAEMU region is currently under way and should be ready before end-2008. One of the most interesting finding of the CAEMC /FSAP is that despite the monetary union there has been relative little financial sector integration in the CAEMC. One of the reasons for this lack of integration is that the financial sectors of the member countries have experienced an uneven development and major banking restructurings. Even though these countries share similar policies in the financial sector area under the common central bank and supervisory authority, the uneven financial sector situation in terms of banks' capitalization and level of non-performing loans in the banks' portfolio have to a large extent hampered interbank activities across countries. Other relevant factors that have contributed to this non-integration are different level of government deficits and domestic arrears, as well as the passive role of the BEAC to intervene in the market to smooth out excess liquidity.

The regional CAEMC/FSAP presents a comprehensive list of recommendations to improve financial sector soundness and performance and enhance access and regional integration. It is important to emphasize that virtually all countries in the CAEMC have undergone a major bank restructuring and a good level of bank soundness has been restored. This together with the planned introduction of a system of government securities and elimination of government access to BEAC credit in 2008-9 should help to revitalize the financial sector and further regional integration.

Also in the WAEMU regional integration has been lacking for similar reasons as in the case of the CAEMC. In recent years, WAEMU countries have undertaken a major bank restructuring and restored soundness. Statutory advances to the Governments by the BCEAO were halted in 2003 and a system of government securities introduced. Also in this region with appropriate policies and coordination and a sound banking system further development in the financial sector and regional activities should take place in the future.

Arab Maghreb Union (AMU)

In North Africa, the countries of the Maghreb established a council to coordinate and harmonize their development plans as well as interregional trade. The five Maghreb countries signed a treaty in 1988 with the objective of safeguarding the region’s economic interests, fostering and promoting economic and cultural cooperation, and intensifying mutual commercial exchanges as a precursor for integration and the creation of a North African Common Market. (Algeria, Libya, Mauritania, Morocco, and Tunisia)

Notwithstanding some progress made by the AMU group, considerable work still lies ahead as indicated in the IMF /Working paper 07/125 (Box 1).

Southern African Development Community (SADC)

In 1980, a group of southern African countries established the Southern African Development Community (SADC). At the time, it was formed as a loose alliance of nine majority-ruled states, with the aim of coordinating development projects to lessen economic dependence on South Africa. South Africa has since joined the consortium, which has now expanded to 14 member states. (Angola, Botswana, Democratic Republic of Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia ,Swaziland, Seychelles, South Africa, Tanzania, Zambia, and Zimbabwe).

SADC, now in its 25th year, aspires to promote self-reliance of member states. It aims to promote economic growth, coordinate economic cooperation, and achieve free trade between member states. SADC is promoting, inter alia, the implementation of SAMOS payments systems to facilitate capital market operations and transfers.

The Common market for eastern and Southern Africa (COMESA)

The objective of COMESA is to promote regional economic integration through trade and investment. The Authority of Heads of State and Government in 1992 adopted a Monetary and Fiscal Policies Harmonization Programme with the objective to achieve a full monetary union in 2025. (Burundi, Comoros, Djibouti, Egypt, Eritrea, Ethiopia, Kenya, Libya, Madagascar, Malawi, Mauritius, Rwanda, Seychelles, Sudan, Swaziland, Uganda, Zambia and Zimbabwe.

Full details on the Programme are provided on-line in the COMESA web-site. The ultimate objective is to establish a monetary union and create:-a single market for goods, services and capital;-competition to strengthen market mechanisms;-macroeconomic policy coordination and harmonization; and-common policies to achieve regional development.

West African Monetary Institute (WAMI)

In 2000, six West African countries created the Monetary Institute to establish a monetary zone known as the West Africa Monetary Zone (The Gambia, Ghana, Guinea, Liberia, Nigeria and Sierra Leone).

The WAMI aims to implement a payments system infrastructure that will interlink all participating countries. This will facilitate the smooth execution of monetary policy operations and efficient transfers within the zone.

According to the authorities, given current trends, every year, new African countries are joining the fold. By the end of the decade, the entire African continent will have in place modern RTGS systems based on a sound infrastructure. As indicated in the WAMI page, “Pressed on by dynamic regional cooperation organizations, the continent will be moving towards a future of economic well-being for its people and attractiveness for foreign investors. This will promote sustainable and equitable economic growth and socio-economic development that will help to ensure poverty alleviation, with the ultimate goal of eradicating poverty.”

Appendix 2:
Overview of Financial Systems in the Maghreb Region

- Although the financial systems in the Maghreb region have developed substantially in the last decade, their financial sectors still need further modernization and regional and global integration.

- The main characteristics of the financial systems in the Maghreb region include the following: (a) bank dominance, and heavy public sector presence in most countries; (b) limited financial sector openness in some countries; (c) bank soundness exhibiting significant cross-country variations; (d) public banks burdened with inefficiencies and a high level of nonperforming loans (NPLs) in certain countries; (e) still embryonic fixed income and equity markets, with the exception of Morocco and Tunisia; (f) nascent institutional investor industry and generally underdeveloped microfinance; (g) shortcomings in the legal, regulatory and supervisory frameworks despite tangible progress; and (h) payment systems in the process of being modernized but still largely cash-based.

Ongoing Reforms and Remaining Challenges

- All five Maghreb countries are well aware of the importance of modernizing financial sectors and have been implementing reforms for some time, with encouraging results. Despite progress and a number of successful reforms in the Maghreb countries – many of which ought to be implemented in the other countries of the region – several problems remain and need to be addressed. Some of the necessary reforms would also facilitate financial integration in the region.

- Strengthen the soundness of the banking systems in all the five countries.

- Increase competition in the banking systems

- Deepen the financial markets.

- Strengthen financial sector oversight

- Upgrade financial sector infrastructure.

Toward Regional Financial Integration

- So far, only limited actions and progress has been achieved within the Maghreb region toward financial integration. A 1991 agreement among the five central banks on payment systems has not been implemented by all the countries. More recently, a long-awaited decision was taken to establish a Maghreb investment bank. The recent interest in reinvigorating regional cooperation is therefore very welcome and would benefit all the countries.

- What can be learned from previous integration experiences? While there is no blueprint on how best to achieve regional integration, useful lessons can still be learned from other experiences, particularly that of the European Union (EU) and Gulf Cooperation Council (GCC) countries. These lessons would include: (a) adopting a gradual approach; (b) consolidating macroeconomic stability in all the countries; (c) strengthening financial markets; (d) harmonizing rules and regulations; (e) improving regional coordination; and (f) lifting restrictions on cross border flows of goods and services.

- Steps toward financial integration:

  - Implementing the necessary reforms in each country.
  - Harmonizing regulatory and supervisory frameworks.
  - Harmonization of financial contracts and standardization of financial information
  - Harmonizing payment systems.
  - Facilitating trade financing
  - Proceeding with the establishment of the Maghreb Bank for Investment and Foreign Trade (BMICE).
  - Gradual liberalization of the capital account

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Washington DC 20037, USA Tel: (1) 202.393 6663 Fax: (1) 202 393 6556

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