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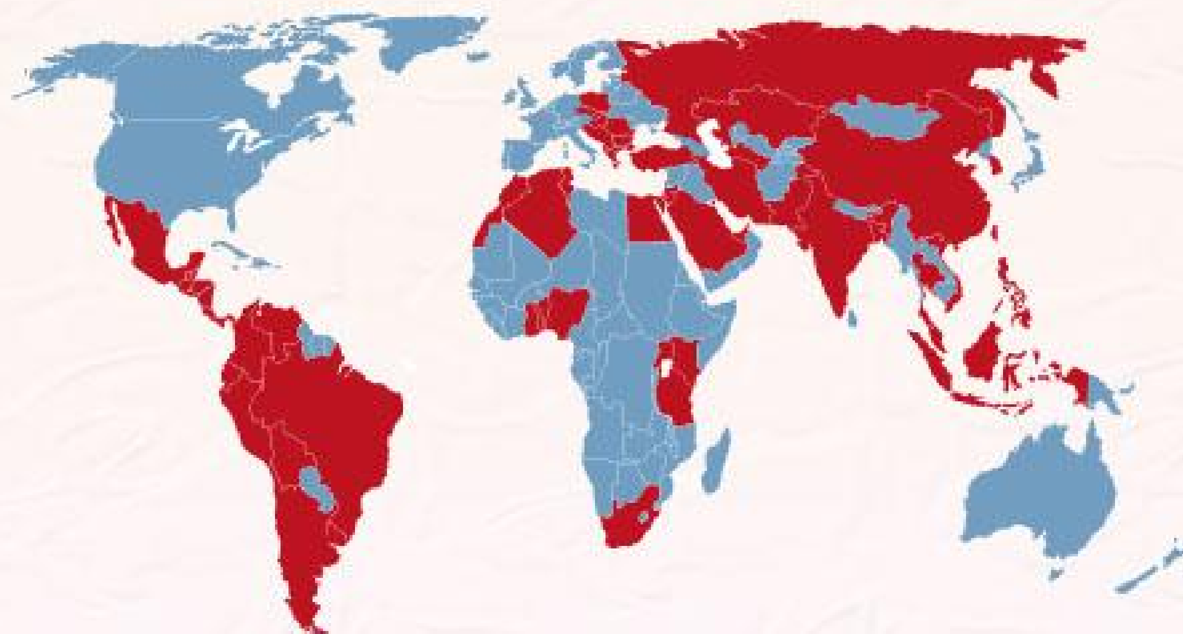

Policies to Support Financial Sector Development in Africa

Philipp M. Hildebrand

Discussion Draft

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AFRICA EMERGING MARKETS FORUM 2008

Policies to Support Financial Sector Development in Africa

by

Philipp M. Hildebrand[1]
Vice-Chairman of the Governing Board
Swiss National Bank

Africa Emerging Markets Forum

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1. Introduction

On November 19 2007 an article in the Financial Times begins with the statement: “It is no longer a matter of *Out of Africa*. Instead it is into Africa”. Investing in Africa has become a hot topic in the leading financial press. Venture capitalists and hedge funds recently seem to have found more and more promising investment opportunities on the African continent. These are very encouraging signs, but the challenges that emerging Africa is facing remain undoubtedly enormous. The financial sector can help master these challenges because it can be a powerful source for growth.

Economic growth is key in development and poverty reduction. There is little doubt that the drivers of sustained economic growth are progress and diffusion of technology and innovation. Technical progress comes in many forms; their characteristic feature is that they increase productivity: more can be produced with the same input. Africa has an enormous potential to increase productivity.

Why is the financial sector crucial for development? The financial sector plays a pivotal role in innovation. Technical progress normally involves some amount of investment activity, for instance, to replace traditional technology by more productive technology. A well functioning financial system can raise the capital required to develop a country and channel it into the right projects. Every country has innovative investment projects waiting for implementation and even in the poorest African country some households have at least temporary savings to contribute to financing such projects. The financial system has to guide these savings into the most profitable investment projects. Technical progress also involves trade, which benefits from a well functioning payments system, too.

What is the recipe for a well functioning financial system? The demands on a financial system vary greatly with development stage and size of a country. It is hardly possible for governments to design an adequate financial sector. Governments are not particularly good at providing financial services. Many examples of nationalized banks in Africa and other parts of the world prove that government involvement in banks lead to politicized banking decisions and investment in projects which are due to fail. The world would look very different if the money wasted by nationalized banks had been spent wisely. A private investor with hard budget constraints who wants to make sure not to loose his own money has a stronger incentive to make a successful and profitable investment than has a civil servant who does not bear the consequences of his decisions. Prospering financial centers stem from a market-oriented approach to the financial sector. There is no need for governments to plan the financial sector in detail. Financial services are no public goods. A good test of market orientation is the extent to which the financial sector can mobilise domestic savings and channel them into domestic projects via private sector credits. It is a good sign when households trust their savings to banks and even small enterprises can secure loans from those banks.

Financial services are no public goods; however, the rule of law and the formal and informal rules that govern economic interactions in a society (called “institutions” in economic jargon) are public goods. The chance that a loan will be made is higher if society establishes clear rules and stands ready to put pressure on the debtor to keep his promise to pay back. Public policy matters a great deal for the development of the financial sector. It does so primarily by strengthening property rights and institutions in general and by providing a sound macroeconomic and regulatory environment.

Institutional weakness has, of course, received much attention in the recent past. Every year, the World Bank’s *Doing Business Report* points out the same three main obstacles to private

investment activity in Africa: a massive bureaucratic burden, widespread corruption, and the resulting high cost of doing private business.

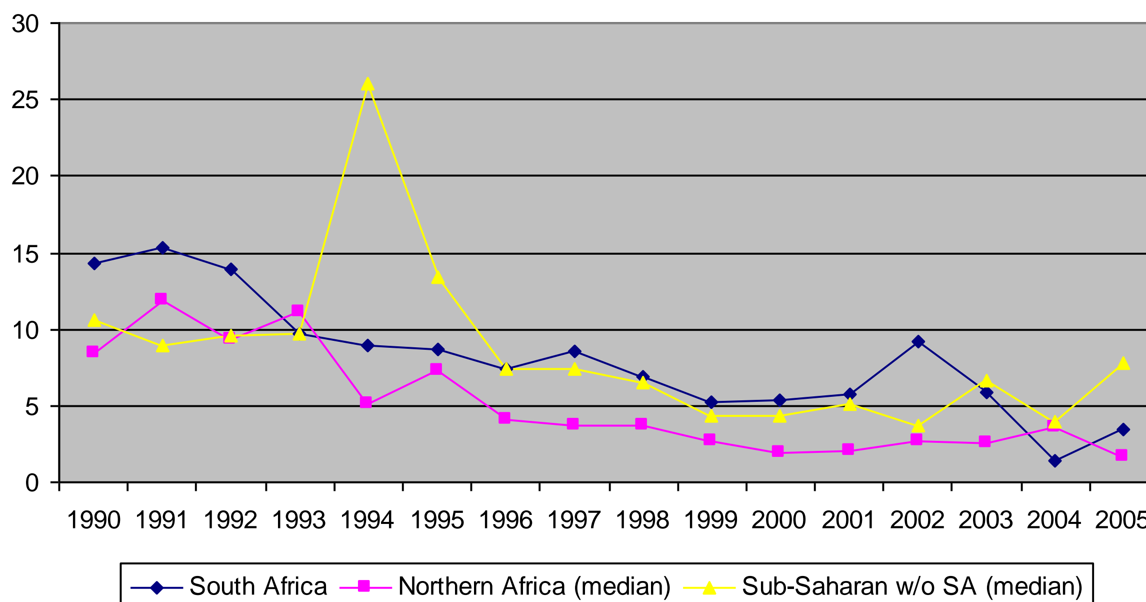
Other areas of public policy that aim to promote economic activity generally receive less attention. The fight against red tape and corruption is unquestionably important. But progress in macroeconomic and structural policy should not be overlooked. The three following activities can have a substantial impact on the environment for doing business: maintaining price stability, maintaining a safe and efficient payment system, and supporting the development of the financial sector.

2. Price Stability

Let us first consider price stability. Low and stable inflation rates allow the private sector to plan for the future, lead to a lower need for costly price adjustments, prevent tax distortions and thus create a stable business environment. On the other side, high and unstable inflation creates random wealth transfers between creditors and debtors. Since their fiscal base is weak, governments in Africa have often relied on seignorage to improve their income stream, creating high inflation rates as a by product. Inflation is a tax on holders of cash and nominal claims.

How has inflation developed throughout the continent in recent years? Figure 1 depicts inflation in Africa from 1990 to 2005. It displays inflation in South Africa, as well as the median inflation rates in 39 other sub-Saharan economies and in 5 North African economies. I focus on the median inflation rate because this measure is not sensitive to large outliers such as Zimbabwe.

Figure 1: Inflation in Africa (in %)

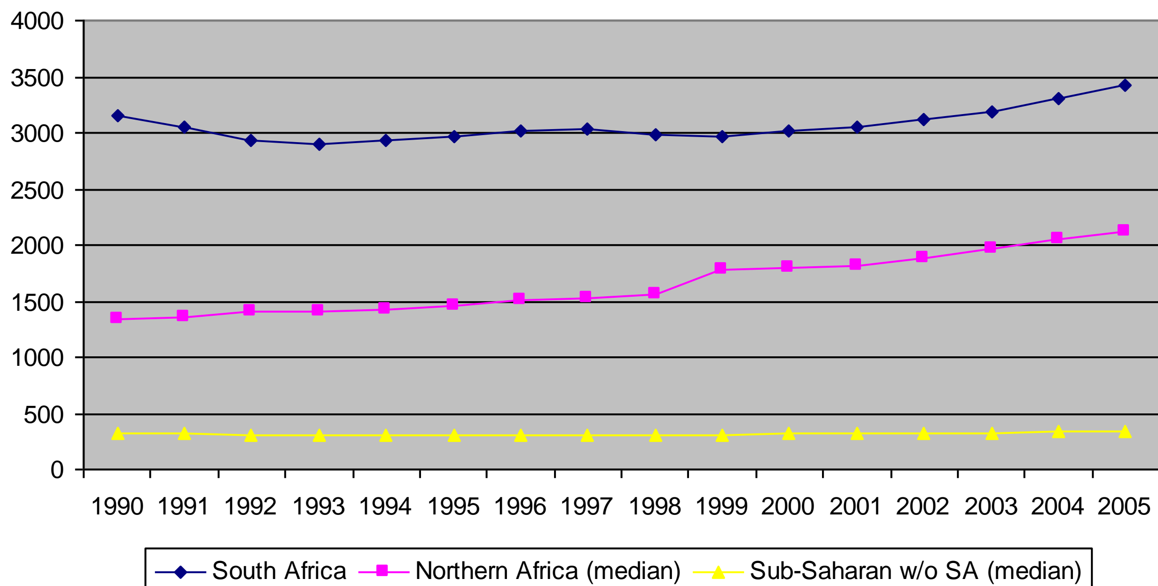


Source: World Development Indicators, World Bank

Figure 1 shows that inflation in Africa has trended downward over the past 15 years, with the exception being the aftermath of the Tequila crisis in 94/95. In South Africa and northern Africa inflation is now well below 5%, while sub-Saharan Africa also displays single digit inflation rates.

The figures displayed suggest that businesses and households in most African countries now enjoy an environment of increasingly stable prices. Undoubtedly, the recent inflation record has contributed to the increasingly robust growth environment. Figure 2 shows that per capita growth has picked up in recent years in parts of Africa. This is particularly true where disinflation was strongest.

Figure 2: GDP per capita in Africa (in constant 2000 USD)



Source: World Development Indicators, World Bank

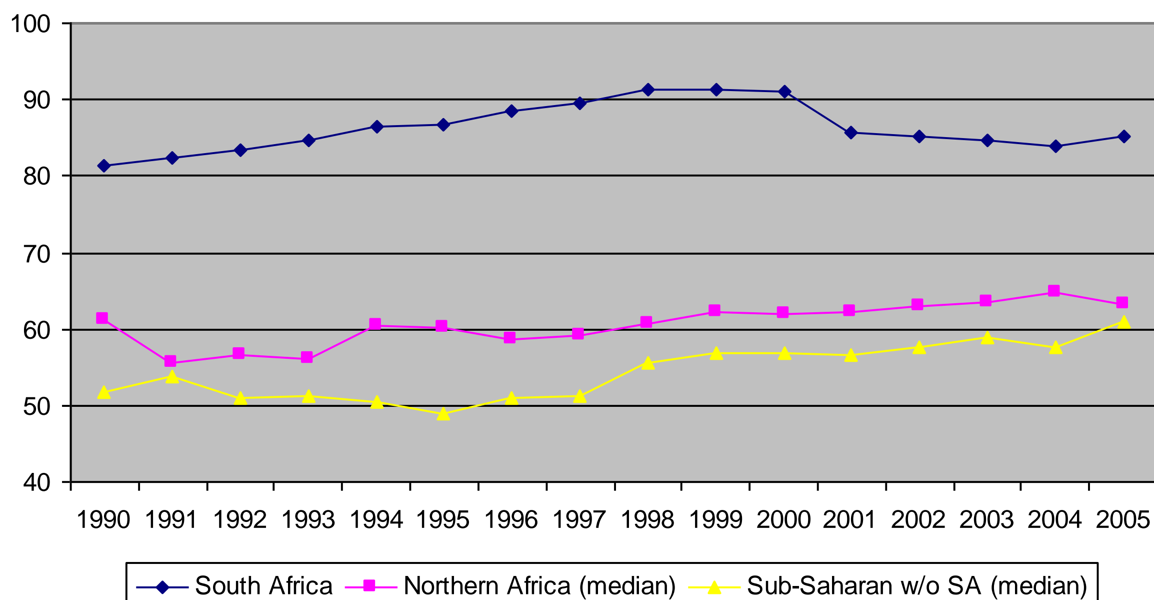
Governments no longer seem to rely on money printing as a revenue source. This is a sound policy development which encourages private sector activity. Going forward, the challenge for African central banks will be to maintain this recently acquired track record. Strengthening governance and accountability at the central bank and in government help to meet this challenge. They make it easier to keep government expenditures in check in times of stress and at the same time they increase the willingness of people to pay taxes.

3. Payment Systems

Next let's look at the payment system. The development of the payment system determines how easy it is for firms and consumers to access and transfer money. Can businesses pay their suppliers by writing a cheque or making an electronic transfer? Or do they have to undergo the cumbersome and insecure process of sending cash physically? Can households pay for consumer goods with debit cards, cheques or credit cards, or do they have to carry significant amounts of cash with them? Can workers in urban areas transfer money to their rural families by simply sending an SMS, or do they have to carry it with them on a dangerous bus ride?

Particularly in Africa, where distances are vast and security is often a concern, the availability of non-cash payment instruments can increase the returns to economic activity for businesses and households. Figure 3 shows that today, most economies in Africa are still strongly cash based.

Figure 3: Share of Non-Cash Money in Africa (in%)



Source: International Financial Statistics, IMF

Both in sub-Saharan and northern Africa, more than one-third of funds available for immediate payments are in cash form. The notable exception is South Africa where the level of non-cash money is above 80%, and thus similar to that of Switzerland. Developments over the past 15 years show a promising picture for other countries on the continent as well. Since 1995, the share of non-cash money has increased from 50 to 60 percent in sub-Saharan Africa, and 55 to 65 percent in North Africa. This mirrors the increased availability of electronic payment instruments available to businesses, but also to households.

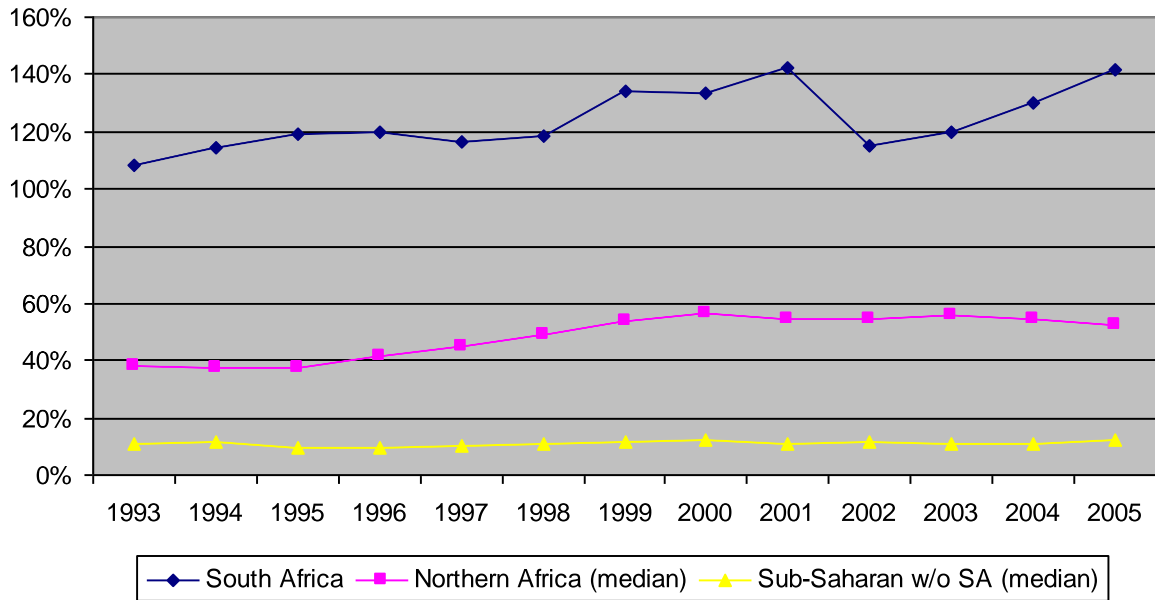
How can authorities foster the further development of safe and efficient payment instruments in Africa? First and foremost, central banks must take a leading role in the development, operation and oversight of necessary infrastructure, such as interbank and retail payment systems. In doing so, it would seem natural to take advantage of international knowledge and expertise. Financial sector regulators can further create a market environment which encourages the entry of new service providers, as well as the development of innovative payment instruments, such as SMS-banking and mobile-banking. As an oversight authority, it is then their task to ensure that new payment services adhere to the security requirement desired by businesses, households and financial institutions.

4. Financial Sector Development

Third, let's take a brief look at financial sector development. An efficient and deep financial sector provides enterprises with debt and equity to finance their growth, thus spurring economic activity. At the same time a deep financial sector can provide households with savings and credit products to smooth their consumption patterns, again increasing their return from economic activity, and reducing poverty.

To what extent have financial sectors grown and become more efficient in Africa in recent years? Figure 4 displays the volume of private credit, as a percentage of GDP, for South Africa, other sub-Saharan countries and for Northern Africa.

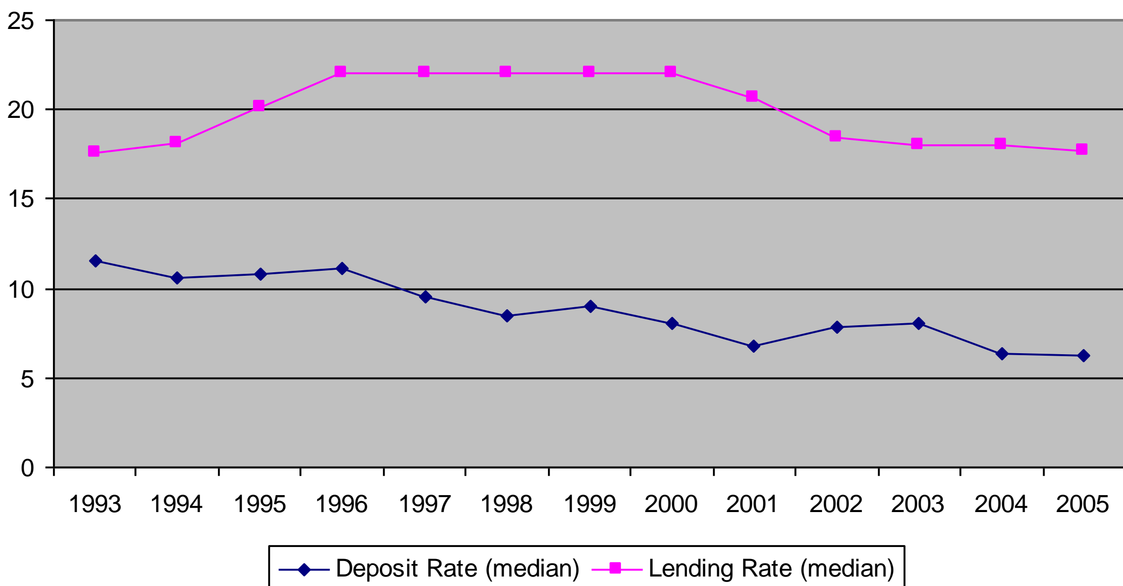
Figure 4: Private Credit / GDP in Africa (in%)



Source: World Development Indicators, World Bank

With credit exceeding GDP, the financial sector in South Africa boasts a similar size to that of many North American and European countries. By contrast, the financial sector is very shallow in the rest of sub-Saharan Africa, with credit volumes at less than 20% of GDP. Even more worrying is that the financial sector has hardly deepened over the past 15 years. Continuing this undoubtedly bleak picture, we see that the financial sector in sub-Saharan Africa has become neither more efficient, nor more competitive in recent years. Figure 5 displays the nominal rates at which banks lend money, as well as the rate they pay for deposits.

Figure 5: Lending and Deposit Rates in Sub-Saharan Africa (w/o SA)



Source: World Development Indicators, World Bank

Lending rates have stayed more or less constant from 1993 to 2005. Since inflation has decreased substantially over this time, the real interest rate that banks charge has actually increased. By contrast, the nominal deposit rate has decreased, so that the real deposit rate has been constant. Together this implies that the interest rate spread charged and earned by banks has increased substantially in the last 15 years.

What can be done to foster deeper and more efficient financial sectors? Bank supervisors should ensure that regulatory requirements do not erode competition between banks and are not prohibitive for new market entrants, particularly foreign financial institutions who may bring cheaper capital and new technology to the sector. Moreover, the development of sustainable microfinance and rural financial institutions to cater to the vast agricultural and microenterprise sector can be fostered by adopting regulatory requirements which suit the limited sphere of activity of these institutions.

Competition prevents banks from charging undue interest rate spreads and provides an incentive to reduce costs. But there are costs of granting loans that banks cannot influence. Banks, for instance, cannot reduce the costs of seizing collateral. Improving collateral law and judicial efficiency is, therefore, an important task of public policy.

5. Conclusion and Issues for Discussion

To conclude, we can state that most African central banks have been successful in reducing inflation. This enables the private sector to plan ahead and engage in contracts without worrying excessively that their proceeds may be eroded by rapidly rising inflation. Participants might have a view on the sustainability of this situation. Can it last or are there risks to price stability?

Payment systems have also been improved, which has reduced the costs of accessing and transferring money for businesses and households. The cash intensity of most African economies suggests, however, that there is still room for improvement in this area. Participants could exchange views on how the use of modern means of payment could be encouraged.

A greater challenge lies in fostering growth and efficiency in the financial sector. The banking sector in many countries of the continent remains small and sadly displays a low level of efficiency and competition. Progress will be made if political interference can be reduced and market mechanisms are allowed to come into play more forcefully. Some countries have already taken that route, they have changed the rules of the game and it shows. Participants might want to spend most of the available time on the question how financial sectors can be made more efficient. How can laws and supervisory practice be changed to allow market entrants to compete effectively in offering financial services? How can laws and supervisory practice be simplified to allow banks to narrow the interest rate spread below levels possible with current technology? Would there be the disadvantages to these changes? Are the changes politically appealing?

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or email us at :
info@emergingmarketsforum.org

The Watergate Office Building, 2600 Virginia Avenue, NW, Suite 201,
Washington DC 20037, USA Tel: (1) 202.393 6663 Fax: (1) 202 393 6556
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