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# Achieving Financial Stability and Growth in Africa

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## Chapter 9: Conclusions

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### Introduction

The aim of this book was to see how the financial systems and their regulation in African low-income countries (LICs), still in their early stages of development, could be better shaped to achieve simultaneously the goals of financial stability and inclusive growth. This draws on understanding the features of financial systems in LICs, both their challenges and their relative strengths, and on possible lessons arising from the global financial crisis, as well as previous experiences of crises in emerging economies.

Finance is crucial for development. Without a well functioning financial system that channels finance to the right places in the right form, inclusive growth is impossible. This is not just a question of the quantity of finance, though this is extremely important, but also what we might call its *quality*. Different types of economic activities (and actors) require different types of finance in terms of cost, maturity and risk characteristics. The more financial systems are able to meet these needs, the more likely they are to be supportive of inclusive growth. As well as its potential to foster growth, however, the financial sector can also generate instability and crises, with devastating consequences. Increasing understanding of the role that financial structure and regulation can play in balancing these objectives in low-income countries was the aim of this research project and resulting book.

LICs have the greatest need for financial systems that can support inclusive growth. In 2013, aggregate per capita income for LICs was US$722, compared with US$4,814 in middle-income countries (MICs), and US$39,116 in high-income countries (HICs).[2]

Table 9.1 describes average financial sector depth by income group, highlighting how the total size of the financial sector relates to income level of countries, and the scale of financial sector development required in LICs.

**Table 9.1: Arithmetic Average Financial Depth Indicators by Income Group (2013)**

| | LIC | MIC | HIC |
|---|---|---|---|
| Private credit by deposit banks to GDP (%) | 18.54 | 41.19 | 101.87 |
| Financial system deposits to GDP (%) | 26.70 | 45.93 | 93.32 |

Source: WDI

Table 9.2 shows that just 12.5% of people in LICs have deposit accounts at commercial banks, compared with more than 50% in MICs. The figures for high-income countries are close to

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[2] Current US$. Source: World Bank's World Development Indicators (WDI)

100%. These differences are reflected in the number of bank branches, which are five times greater in middle-income to low-income countries, and ten times greater in HICs.

**Table 9.2: Average Financial Access Indicators by Income Group (2011)**

| | LIC | MIC | HIC |
|---|---|---|---|
| Bank branches per 100,000 adults | 3.62 | 17.03 | 32.67 |
| Depositors with commercial banks (per 1,000 adults) | 124.9 | 504.9 | - |

Source: WDI

While credit is scarce in countries at lower levels of income, it is also expensive. As shown in table 9.3, average lending-deposit spreads in LICs are nearly 15%, compared with 7.65% and 4.44% in MICs and HICs respectively (we return in some detail to this issue below).

It is unlikely that these differences in spreads simply reflect greater risks. If this were the case we would expect to see roughly similar level of profitability across country income groups. Instead, table 9.3 shows that average profitability of banks is much higher in lower-income countries. Returns on both assets and equity are roughly three times higher in LICs than in HICs.

**Table 9.3: Average Financial Sector Profit and Spread Indicators by Income Group (2013)**

| | LIC | MIC | HIC |
|---|---|---|---|
| Bank return on assets (% after tax) | 2.15 | 1.40 | 0.80 |
| Bank return on equity (% after tax) | 19.17 | 13.04 | 6.20 |
| Bank lending-deposit spread (%) | 14.87 | 7.65 | 4.44 |

Source: World Bank Global Financial Development Database (GFDD)

As well as risk, higher spreads could be because of higher costs. As shown in table 9.4, overhead costs are far higher as a share of assets, but the difference is small when total costs are compared to income.

**Table 9.4: Average Financial Efficiency Indicators by Income Group (2011)**

| | LIC | MIC | HIC |
|---|---|---|---|
| Bank cost to income ratio (%) | 60.99 | 56.27 | 55.52 |
| Bank overhead costs to total assets (%) | 5.54 | 3.82 | 2.07 |

Source: GFDD

Conventionally it is argued that excessive spreads (and profits) result from a lack of competition. Two measures used to measure competitiveness are shown in table 9.5. These results appear less conclusive. While bank concentration is higher in LICs than MICs, there is little difference with high-income countries. Other indicators also suggest that competition is somewhat lower in LICs, but the orders of magnitude are unclear and competitiveness in HICs is not generally higher than that in MICs. Furthermore, as reported in the case studies, though the number of banks has increased significantly in recent years, in countries like Ghana, spreads have hardly fallen.

**Table 9.5: Average Financial Competitiveness Indicators by Income Group (2012)**

| | LIC | MIC | HIC |
|---|---|---|---|
| Bank concentration (%)[3] | 75.74 | 66.06 | 74.29 |
| H-statistic[4] (Closer to 1 implies greater competition) | 0.46 | 0.63 | 0.64 |

Source: GFDD

To summarize, compared with countries at higher levels of income finance is more scarce in LICs, but also more expensive. Financial intermediaries are less efficient, but also much more profitable, and competitive pressures may be less. Financial exclusion remains the norm for most people. The scope for financial sector development is thus very large in LICs. The potential for this to contribute to inclusive growth is similarly large. In this context, it is important to welcome that growth in the recent period in Sub Saharan LICS has been significant, which is very positive, but it has not been inclusive; furthermore, there are concerns whether this growth can be sustained, if the global economy continues to grow at a slower pace, and at a time when commodity prices seem likely to remain at lower levels. In this context the challenges for sustained growth are larger and may therefore require a better and better functioning financial sector.

At the same time, the potential risks of financial instability are also significant. This is evidenced by the numerous and costly crises that have occurred in recent decades, both in emerging and high-income economies. Sub Saharan African LICs have suffered very few

[3] The assets of three largest banks as % of total banking assets.

[4] "A measure of the degree of competition in the banking market. It measures the elasticity of banks revenues relative to input prices. Under perfect competition, an increase in input prices raises both marginal costs and total revenues by the same amount, and hence the H-statistic equals 1. Under a monopoly, an increase in input prices results in a rise in marginal costs, a fall in output, and a decline in revenues, leading to an H-statistic less than or equal to 0. The closer the H-statistic is to 1, therefore, the greater the implied competition." (GFDD Database explanatory notes).

banking crises in the last decade, which is also positive, but this does not imply that there is room for complacency, especially if financial sectors grows significantly and fast. There is no reason why Sub Saharan LICs should be different from other regions, unless careful prudential measures are taken.

A difficult balancing act is therefore required. Financial sector development is crucial for inclusive growth, but it also brings greater risks of instability and crises. Effective regulation is the key to achieving and maintaining this balance. The research described in this book has sought to better understand how regulation in LICs should be designed to balance inclusive growth with financial stability.

There have been two main elements to this research. Part 1, which is covered in the earlier chapters of the book, entailed reviews of the literature. The aims were to a) identify and review the literature on the most important issues with respect to financial regulation, growth and stability in LICs, and b) identify the most important research gaps. The second part of the research built upon this foundation with four detailed case-studies. These explored how key issues of financial regulation, inclusive growth and stability manifest in different country contexts. The studies were undertaken in Ethiopia, Ghana, Kenya and Nigeria. The country studies show that, although all in the early to middle-stages of financial sector development, their financial systems are already significantly different from each other. Ghana and Kenya have systems with open capital accounts, which are dominated by private banks. Nigeria is a large, oil-based economy, with a more sophisticated financial system and domestic banks penetrating other African markets. Kenya also has a large number of banks in neighboring countries. Ethiopia has a heavily regulated bank-based financial sector in early stage of development, with a large (though decreasing) role for government owned banks – including a large public development bank – and restricted capital account opening. These differences are partly due to previous policy choices, and partly because initial conditions, such as economic structure, are different as well.

Despite these large differences, there are also similarities, as detailed in the country chapters in the second part of the book. The lessons we can learn from these national differences and similarities are distilled in this concluding chapter. Before doing so, however, we first recap the key findings from the general analysis and review chapters contained in the first part of the book. After examining the most important results from the country chapters, the chapter concludes with some policy recommendations and suggestions for future research.

## 1. Key issues arising from the literature

For the issues of financial stability referred to in this book, a significant event in recent times was the financial crisis of 2007/8. Most refer to this as the 'global financial crisis', while others – more accurately – term it the 'North Atlantic financial crisis. The latter description captures the fact that the crisis emanated from the US, spread to Europe, and resulted largely from the practices of US and European financial institutions. The former description captures the fact that the effects of this crisis have been global, though unevenly distributed.

As well as financial and economic impacts, the crisis has had other global effects, notably on academics', policy-makers' and regulators' views on financial sector development in general, and financial regulation in particular. On structure, the financial institutions, mechanisms and markets that developed in the world's major financial centers could no longer be viewed always as an example to which developing countries should aspire. Similarly, the 'sophisticated' risk-

management practices of these financial centers proved to be ineffective at best, and highly problematic at worst while the 'light-touch' regulation that accompanied these sophisticated techniques had disastrous consequences. For both financial sector structures and regulation, therefore, policy-makers in countries at all levels of development have had to think again.

In Chapter 1 Griffith-Jones et al. describe some of the most important findings of recent analysis. An important recent finding, now rather widely accepted (anticipated earlier by only a few prescient academics), is that there are limits to financial sector development beyond which expansion begins to have a negative impact on growth. Recent research, for example at the Bank of International Settlements and at the International Monetary Fund, estimates this to be between 80-100% of private credit to GDP. As shown in table 1, this is about the average level of HICs today, double that for MICs, and five times the average level in low-income countries. Therefore this link is less relevant for LICs than for countries with higher incomes. However, the link has some relevance for countries at all income levels for three reasons.

First, knowing that expansion of the financial sector begins to constrain growth beyond a certain point allows developing country policy makers to take a long-term view of financial sector development. Second, income-group averages mask wide variations. While the average figure for HICs for the private credit to GDP is around 100%, the highest is 284%. For LICs the highest level is 50%. Although the 'limit' remains above what exists in any LIC, the lower end of the range (i.e. 80%) is not so far away for some LIC countries. LIC country policy-makers need to note this.

The third reason why this matters is that the optimal size of the financial sector will not be the same for all countries. As described by Spratt (Chapter 2), a relatively small financial sector providing affordable and appropriately structured finance to the real economy will be more developmentally beneficial than a large financial sector focused on trading esoteric financial products. Credit to enterprises seems to have greater growth impacts than credit to households. This may be more the case in LICs which may suffer more from supply constraints than demand constraints. As the economy develops, and becomes more diversified, this may change. The composition of the financial sector is an important determinant of its activities, and policy and regulation have a major role to play in helping to shape this composition.

Griffith-Jones et al., in Chapter 1, discusses the potential importance of public development banks as part of this mix as one of the insights that have been 'rediscovered' since 2008. The crisis showed how development banks could play a crucial counter-cyclical role, stepping in when private finance dried up. This prompted a broader reassessment of their record and potential. Once common in many countries, the record of development banks has not always been positive. Following a series of influential studies linking government-owned banks to lower growth, many development economists assumed they were a thing of the past.

But this was never true. Development banks have been central to the growth of large emerging economies (e.g. Brazil, India and China), and remain integral to the financial landscape in highly successful developed economies like Germany. As well as playing a counter-cyclical role, these institutions can help provide the long-term 'patient' finance, that is key to the development process, but which the private sector rarely provides at the scale needed. Furthermore, they may be valuable for funding structural transformation, essential for long-term growth. More recent research, which controls properly for institutional quality, does not find that government ownership of banks is associated with lower growth. Indeed, when the crisis period is included, the opposite may be true.

As argued by Griffith-Jones et al., and supported by the evidence in Spratt (chapter 2), there thus remains a strong case for public development banks. There are risks, but the experience of some countries shows that these can be overcome. The question may therefore be not whether to create a development bank per se, but how to design and run a *good* development bank.

The final issue highlighted in chapter 1, seems to be the most important one. As understood by those working on financial crises in developing and emerging countries for many years, this relates to the importance of the *rate* of credit growth. An overly rapid expansion of credit – regardless of the starting level and the exact form this credit assumes – is strongly associated with financial crises.

Whether in the 2007/8 crisis, in the Nigerian financial crisis of 2009 described in this book, or many of the financial crises that have occurred around the world since the 1980s, rapid credit expansion tends to see finance allocated inefficiently (lowering long-term growth prospects), and asset price bubbles inflated, triggering instability and subsequent collapse. Given the perennial nature of such events, with us in one form or another for hundreds of years, there is every reason to think they will continue, unless financial regulation is far more effective. Rather than assuming that 'this time it's different', Griffith-Jones et al. argue strongly that regulation needs to counter these trends, with counter-cyclical(often called macro-prudential) mechanisms deployed to dampen credit growth when this becomes excessive, and vice versa.

In an extensive review of the literature in chapter 2, Spratt examines the evidence on how financial structures affect inclusive growth and stability in LICs, and how financial regulation affects these structures, as well as the behaviour of financial sector actors. The evidence can be organised into three categories: the supply of finance (including access to finance); the cost of finance; and the maturity of finance.

Chapter 2 assesses these categories with respect to three actors – firms, households and governments. In each case evidence is assessed on what financial structures and behaviors are most likely to balance growth with stability, and how financial regulation could be designed to encourage these structures and behaviors.

Given the dominance of banks in LIC financial systems, and the importance of credit in determining growth and stability outcomes, the chapter focuses largely on bank credit. The potential of capital markets with respect to inclusive growth and stability is also reviewed. As LICs generally lack the structural features required to obtain the benefits of capital markets – such as sufficient liquidity, for example – the chapter argues that policy-makers in LICs should focus on improving the impact of the banking sector on growth and stability, and ensuring that the capital account is managed carefully to support this goal.

The first area to consider is the supply of finance to firms and households. In both cases, access to finance (of any kind) is a major issue in LICs. Firms, particularly small-and-medium-enterprises (SMEs), regularly cite lack of external finance as the major constraint to growth. Financial inclusion of households in LICs is also the exception rather than the norm. Many of the reasons are the same: information on creditworthiness is rarely available in third-party form; transaction costs of lending small amounts are high; borrowers may be located in relatively remote rural areas. As we saw in the tables above, the total size of the financial sector – i.e. total credit available – is relatively low, and bank branches are few. As a result, finance tends

to flow to activities less affected by these problems, such as blue-chip corporates and government.

Regulation can be used to reduce these problems for incumbent institutions: encouraging information sharing and credit bureau, and fostering innovative practices to reduce transaction costs, for example. Using regulation to affect the composition of financial institutions may also be very important. As proposed in chapter 1, and supported by evidence gathered in chapter 2, increasing the supply of finance to diverse sectors is likely to be easier with a diverse set of financial institutions: large and small banks; diversified and sector-specific; commercial and development-oriented. Microfinance Institutions (MFIs) credit unions, cooperative banks and mobile banking will be a part of this. As well as supporting financial inclusion (households) and inclusive growth (SMEs), such an'eco-system' may also be positive for financial stability, as institutions will be exposed to different sectors and risks.

The argument for diversity also applies to large-scale infrastructure projects, which also face severe – though different – financing constraints. The case made for development banks is also relevant here. There is more potential to involve external financial institutions in infrastructure. Often these will be multilateral or bilateral development banks, with commercial institutions also participating in projects. The presence of an effective national public development bank is likely to increase the likelihood of successfully financing such projects, and improve their development outcomes.

Chapter 1 makes a case for comprehensive regulation of all financial institutions. This is supported by evidence presented in chapter 2, where it is also argued that regulation should be tailored to the specific characteristics of different sectors. If the aim is to encourage institutions to act in different ways, then regulation should be designed to support rather than stifle this. Though regulation should be comprehensive, it should be proportionate to the scale and the systemic risk of financial institutions, as well as their specific features.

The supply of credit to government is considered in the context of 'crowding out' and, above all, debt sustainability.

As mentioned previously, the cost of credit in LICs is also important, including for small borrowers, due to the high rates charged by commercial banks but also by many MFIs. While not certain, it is more likely that MFI rates more accurately reflect risk than is the case with commercial banks. This does not mean that the resulting debts are sustainable, however. Credit will only be developmentally beneficial – to firms, households, or indeed governments, if invested in activities with returns greater than the rate of interest charged. Increasing levels of non-performing loans (NPLs) in the microfinance sector suggest, at the very least, that this is not always the case. Debates on whether MFI rates should be capped continue.

As we saw very clearly in the US sub-prime market, extending credit to the financially excluded is not an end in itself. It will only be beneficial – for both inclusive growth and stability – if borrowers can invest this finance productively, and if they have the financial capacity to pay them back. If not, the extension of credit is liable to make matters worse, not better, for poorer borrowers, as well as for financial system stability.

As for governments' borrowing, if their costs are very high, the resultant debt service payments reduce their ability to fund other activities. If financial institutions in LICs can obtain very good returns by just lending to government at high, risk-free rates, they will be less inclined to lend

to the other parts of the economy. By providing financial instruments and building a yield curve, government borrowing is an important driver of financial sector development in LICs.

The final area to consider is the maturity of finance. Much of the finance that is available in LICs is short-term and expensive. As well as designing regulation to encourage banks to take a longer-term view, domestic investors such as pension funds that naturally take a long-term view, also given the long term nature of their assets, and can commit large-scale finance are needed. This is a long-term process, but infrastructure needs in LICs are pressing and immediate. Again, we have a strong case for public development banks to help fill this gap, as well as help channel long- term funds, such as from institutional investors, to long term investment.

External finance can also play a role, but international direct investors may demand very high returns to offset the risks they associate with LICs. This does not mean that there is no scope for such investment, but is probably best deployed in conjunction with multilateral and bilateral development finance institutions, either as co-investors or as suppliers of risk mitigation.

Chapter 3 by Isabella Massa examined the issue of private capital flows and capital account management in LICs in detail. In particular, this chapter surveys the literature on the growth benefits and risks of private capital flows as well as on capital account management tools and their effectiveness. Overall, the analysis confirms that private capital flows, in some cases and under certain conditions, may carry important growth opportunities. A significant share of the literature focuses on the growth impact of FDI flows on growth in LICs, while much less quantitative work has been done on growth benefits of other types of private capital flows, especially bond flows and international bank lending. This is a cause of concern, as bond flows (especially to sovereigns) are becoming an important part of private capital flows in several sub-Saharan African LIC countries.

Notwithstanding their growth benefits, private capital flows are also found to be a significant source of risks. Indeed, sudden surges in capital flows can lead to appreciation and volatility of real exchange rates, to inflation, stock market booms, and to credit expansion. Moreover, sudden capital flow reversals or stops can lead to depletion of reserves, sharp currency depreciations, as well as to currency and banking crises. Private capital flows are thus a double–edged sword, and therefore, it is important to develop adequate and effective capital account management policy tools.

A number of policy measures may help manage surges in capital flows, as Massa discusses. These include capital controls, macroeconomic measures (i.e. official foreign exchange intervention, exchange rate intervention, and fiscal policy), and structural reforms (i.e. financial sector reforms including prudential regulation and supervision, and easing restrictions on capital flows). The evidence on the types of capital account management tools that have been used in LICs over time is still limited and much more detailed information on the issues that might arise in implementing specific capital account management tools in LICs is needed.

The debate on the effectiveness of capital controls regained momentum in the aftermath of the 2008-09 crises. A broad consensus is emerging that capital controls may be a good tool to moderate the impact of capital flows (e.g. to prevent the build-up of financial sector risks), but they should be used in coordination with other macro-prudential tools to prevent asset inflation and overvaluation. An important development is the significant change in position of the International Monetary Fund (IMF), which until not long ago had a position broadly against

capital controls and favored capital account liberalization, while in the aftermath of the 2008-09 crises, it decided to endorse the use of capital controls under certain circumstances.

A number of structural reforms may help manage capital flows, as Massa discusses. Financial sector reforms, which include among others prudential regulation and supervision, are a capital account management tool that aims to influence indirectly capital inflows or outflows with the objective of reducing the vulnerability of an economy to systemic financial crises. Particularly relevant in this context are regulations on currency mismatches in the balance sheets of financial and non-financial agents. In this context, it is important to examine whether regulatory measures should be done via domestic prudential policies (e.g. regulating currency mismatches in the balance sheets of banks) or through capital controls, by analyzing their respective advantages and disadvantages. More precisely, domestic financial regulation may work for loans channeled through the banking system, whereas loans lent to nonfinancial companies directly may require capital controls, if they become too large.

The evidence on the effectiveness of macroeconomic measures to manage capital flows is mixed across the different types of policy instruments, with fiscal tightening appearing to be the most effective macroeconomic policy tool, although it is difficult to implement. The evidence on the effectiveness of prudential regulation is instead still relatively scarce. In particular, there is a research gap on whether regulatory and supervisory practices originated in the developed world may be successful in LICs that are characterized by different structural features, stage of development, and institutional capacities.

Chapter 4 by Ricardo Gottschalk discusses the regulatory challenges facing LICs, with a focus on capacity issues. Its starting point is that African LICs are not insulated from financial globalization despite their relatively low levels of financial integration, and therefore are vulnerable to destabilizing effects of financial shocks generated elsewhere. Given this context, the chapter discusses in particular the challenges this grouping of countries face in adopting complex regulatory approaches developed internationally, how to deal with foreign banks in their jurisdictions, and how best to manage risks arising from financial integration, as a result of capital account liberalization.

The chapter shows that African LICs are responding to complexity in financial regulation by slowing down on the implementation of the most challenging aspects of it, particularly on Basel rules. Moreover, they are choosing regulatory tools that are simpler and more suitable to their needs. Also, they are investing in regulatory capacity, although important regulatory and supervisory gaps remain – for example, they still lack counter-cyclical tools to address systemic risks and insufficient assessment of foreign exchange position of banks, although interviews with African regulators indicate that they are making progress in these areas, as reported towards the end of chapter 4 and below in this chapter.

The chapter makes the point that the issue of capacity should be addressed with caution. Capacity to deal with complex rules may indeed be missing. However, complexity has recently been challenged both by developed country and developing country regulators, on grounds of ineffectiveness and inappropriateness. The chapter concludes that if simpler – and more effective – regulation is adopted by African LICs, then there is evidence summarized in the chapter showing that such countries do, on the whole, have the capacity to put in place a regulatory system appropriate to their needs and that is sufficiently good to ensure the safety of their financial systems. The few financial crises that the region has suffered more recently

have had more to do with inappropriate policy choices than with capacity for effective banking regulation, as the Nigerian case discussed further below demonstrates.

Having explored what the literature tells us about financial regulation, inclusive growth and stability in LICs, we now consider the most important conclusions and lessons emerging from the country study chapters, which form the second half of the book.

## 2. Case-study findings

The broad analysis outlined in section 1, allowed us to identify the key questions, that would help frame the case studies; these questions were outlined in Chapter 1. Now we first explore what we have learnt from the case-studies, both broadly and in relation to the specific questions addressed. We split here the discussion first in terms of the domestic sector, before examining later issues with respect to the external sector.

### 2.1. Domestic credit, inclusive growth and stability

The case studies show that LIC banks are well- capitalized and very profitable (see Tables 9.3, 9.9 and 9.10 in this chapter, the first for average of LICs, and the latter two Tables, for indicators for our four case study countries, which all have higher return on equity, than the already very high average for LIC countries, at 19%, in contrast with average for HICs at 6%). This is clearly positive, as the former provides a valuable buffer against financial instability. However, their very high levels of profits show that banks are charging their clients excessively, mainly through high spreads (see table 9.3 above and 9.6 below). The resulting high cost to borrowers is a clear problem, for the growth of the rest of the economy. In a recent empirical study, Aizenman et al (2015) show that for Latin America and Asia the faster the growth of financial services and the larger the lending-deposit interest spread, the slower the growth of the manufacturing sector. The authors call this a financial Dutch disease, which could have similar effects in African LICs. Further research is clearly required on this important issue.

A common feature among the countries under study is the extremely high levels of spreads, although this is reportedly less so for Ethiopia. In Ghana and Nigeria, , but also in Kenya, spreads are not only high but have not come down through time (see also data presented in case studies), despite a growing number of banks, including foreign banks, which should lead to increased competition. There are some exceptions, like Tanzania, where spreads have come down significantly in the last 10 years to around 5%. High spreads, however, occur for most LICs (the average spread for LICs in 2013 was 14.87% in 2013, and 11.4% in the 1990-2012 period, see again Tables 9.3 and 9.6).

Our case studies also see spreads remain high despite technological improvements and, in the case of Kenya, creation of credit reference bureaus to reduce asymmetries of information and the establishment of branches across the country to reduce costs associated with transportation of cash.

The common culprits suggested by banks to explain this phenomenon include: high transaction costs, difficult business environment, poor infrastructure services, high salary costs (the latter especially among foreign banks), and high default rates.

**Table 9.6: Spread (lending rate- deposit rate) in %, 2013**

| | Kenya | Ghana (*) | Ethiopia | Nigeria | LICs (**) |
|---|---|---|---|---|---|
| General | 9.5 | 21.8 | 6.5 | 15.6 | 11.4 |
| SME's | 12.0 | | | | |

* Year 2012.

**LICs: 1990-2012 average

Source: Central Bank of Kenya, Bank of Ghana, Central Bank of Nigeria, Central Bank of Ethiopia

However, in relation to the role of default rates, the evidence is that banks in Africa lend to creditworthy borrowers, whose default rates are low, not high, and which therefore do not justify high spreads (see case study chapters for default rates). The high profitability of banks would support this, as high default rates would sharply reduce profit margins.

This is illustrated by the case of Kenya (see chapter 5). In Kenya, total bank profits before tax increased from about US$ 70 million in 2002 to US$ 1,256 million in 2012, an average annual growth rate of 38.7%. The main sources of income were interest on loans and advances (average of 49.6% of total income during the period), which increased over time reflecting an increase in their spreads. This increase in profits seems excessive.

As described in chapter 2, a common policy recommendation to lower interest rate spreads is to increase banking competition, especially by attracting foreign banks to domestic markets. The expectation is that foreign banks bring new technology, introduce better management practices and have lower transaction costs. But if more competition in the system, including from foreign banks, does not contribute to lower spreads, as the evidence seems to suggest, then regulatory measures might be a way to tackle the problem.

The chapter on Kenya reports that a committee set up by the Kenyan National Treasury recommended the introduction of a common reference rate, which banks would have to follow. Where they charge above the reference rate, they would have to explain this. Even if this measure does not reduce spreads, it would at least increase transparency and help uncover the factors underlying high spreads, thus facilitating further corrective measures, which may even contemplate capping if all else fails. Indeed, other countries might wish to consider adopting common reference rates, and possibly contemplate capping as well.

**Table 9.7: Credit to the private sector/GDP in %, 2010**

| Kenya | Ghana | Ethiopia | Nigeria |
|---|---|---|---|
| 33.8 | 15.3 | 17.2 | 24.9 |

Source: African Development Indicators, AfDB (2013) except for Ethiopia which is World Bank (2013)

Together with cost, the supply of finance (or access to finance) is a major issue in Africa. As Table 9.7 shows, credit to GDP in the case study countries is relatively low, especially in Ghana and Ethiopia. Amongst the case study countries, Kenya is making progress in expanding credit to SMEs as well as providing basic banking services to the wider population, the latter particularly through its innovative mobile banking operator M-PESA. The combination of competition and new technology are driving local banks to reach the lower end of the market.

They are able to make significant profits, while taking calculated risks. Interestingly, foreign banks are starting to follow local banks in trying to expand their client base. However, even in Kenya, 25 per cent of the population remains excluded from financial services.

While microfinance institutions partly fill the gap, they are focused more on individuals and micro-entrepreneurs. Medium sized and even many small enterprises are not served by micro-finance institutions, in what Justin Lin has called the "missing middle" (Lin, 2013). As suggested by literature reviewed in chapter 2, there may be a case for smaller and more decentralized banks being better at providing credit to small and medium enterprises, as they have fewer asymmetries of information and lower transactions costs, partly as they may pay their staff more reasonable salaries.

As well as a more diverse mix of financial institutions, the way that these institutions are regulated is important. Banks are required to set aside capital for all the loans they make. The introduction of the Basel Capital Accord in the 1980s, and its subsequent adoption as the international standard, provided an important mechanism to prevent international competition resulting in a lowering of capital adequacy over time.

As we can see from table 9.8, capital adequacy levels in our case-study countries remains far above the required Basel level. There are good reasons why regulatory capital should be higher in lower-income countries, as risks to the banking sector are also higher, for example from external shocks. While stability may be furthered by capital requirements at high levels, they may discourage credit, particularly for borrowers deemed to be relatively high risk – i.e. the crucial SME sector. More research is needed on the appropriate level of capital in different LICs.

**Table 9.8: Capital adequacy in %, 2013**

| Kenya | Ghana | Ethiopia | Nigeria |
|---|---|---|---|
| 23.2 | 18.6 | 17.9 | 17.2 |

Source: Bank of Ghana, National Bank of Ethiopia, Central Bank of Kenya, Central Bank of Nigeria and IMF

The final issue identified is maturity. Bank credit in Africa is mostly short term, in the form of consumer credit to households and working capital to businesses. So the challenge is how to increase provision of long-term finance, to support investment in sectors, such as infrastructure, agriculture and manufacturing. Ghana, Kenya and Nigeria have capital markets, but these are not sufficiently developed to provide longer term financing to the extent required. The banking system will remain the most important source of finance in African LICs, and should provide long-term finance to sustain rapid growth.

**Table 9.9: Return on assets in %, 2009-2012 average**

| | Kenya | Ghana | Ethiopia | Nigeria |
|---|---|---|---|---|
| Foreign and local private banks | 4.6 | | | |
| Banks with state ownership | 3.7 | | | |
| State-owned banks | 3.1 | | | |
| Average total banks | 3.4 | 3.7 | 3.3 | 1.9 |

Source: Central Bank of Kenya, Bank of Ghana, National Bank of Ethiopia, Central Bank of Nigeria and IMF

**Table 9.10: Return on equity (total capital) in %, 2012**

| Kenya | Ghana | Ethiopia | Nigeria |
|---|---|---|---|
| 34.2 | 26.7 | 34.2 | 20.2 |

Total capital: average capital used to calculate the ROE includes retained earnings, profits, and loss.
Source: Central Bank of Kenya, Bank of Ghana, National Bank of Ethiopia, Central Bank of Nigeria and IMF

**Table 9.11: Return on equity (core capital) in %, 2009-2012 average**

| | Kenya | Ethiopia |
|---|---|---|
| Foreign banks | 46.3 | |
| Local private banks | 44.6 | |
| Banks with state ownership | 34.1 | |
| State-owned banks | 24.6 | |
| Average total banks | | 42.8 |

Core capital: average capital used to calculate the ROE excludes retained earnings, profits, and loss.

Source: Central Bank of Kenya, Bank of Ghana, National Bank of Ethiopia and IMF

Among the case studies, Ethiopia can be singled out as a country with a strategy for long-term credit provision, via its public development bank, with funding coming from private banks and the government owned commercial bank. Although the mechanism to achieve this in Ethiopia appears to work well, in that the development bank is able to serve priority sectors including manufacturing and infrastructure, it seems idiosyncratic and may only be possible due to a strong state and the very early level of development of its financial system. In any case experiences like that of the Ethiopian development bank need further research, to evaluate in more detail its' effectiveness, both in terms of funding long term growth and structural transformation and in terms of commercial returns. Whilst it may not be directly replicable in other countries, it does suggest that other African countries could find their own ways to tackle the problem of long-term finance and support long-term growth.

Given the concerns about financial inclusion and lack of sufficient availability of long-term finance, and support for sectors such as SMEs. African policy makers and regulators know more needs to be done. What they envisage are financial systems that can provide more and cheaper finance, and long-term finance for larger productive and infrastructure projects, and that finance reaches the poorest. Their view is that, to this end, their financial systems should become more diversified, as clearly supported by the literature. Within this common vision, a greater role could be played by well-run public development banks, especially in the provision of long-term credit, as is the case in many successful countries in Asia (Hosono, 2014), Latin America (Ferraz, 2014) and Europe (Griffith Jones et al).

2. <u>External credit, growth and stability</u>

To the extent that countries such as Ghana and Kenya are graduating towards middle-income status, they will increasingly use private foreign finance for funding. Too much dependence on foreign capital is risky, especially if it is of a short- term nature, and/or that currency mismatches become significant. In all, foreign capital creates the risk of excessive external debt and vulnerabilities in their financial systems, whilst having an unclear effect on growth (see chapter 2 for discussion of external debt sustainability and chapter 4, for in-depth analysis and review of the evidence for LICs).

As capital flows are an important conduit of risks and source of financial vulnerability, the country studies examined carefully the issue of capital account management. In the Ethiopian case this sort of risk is very limited, because the country has a fairly restricted capital account, which essentially allows only for foreign direct investment and some borrowing by the Government on the international bond market. Portfolio flows are not permitted, and banks are not allowed to borrow from abroad.

In Ghana, Nigeria and Kenya, capital accounts are fairly liberalized, letting in all forms of capital, including short-term bank lending and portfolio flows. The country studies show that this policy stance has created important vulnerabilities in all three countries. The Nigeria case is interesting, as the drying up of capital flows to the country in late 2008 and early 2009 was a major contributory factor to the banking crisis the country suffered in 2009. The country studies also show that both Kenya and Ghana have large current account deficits and are therefore vulnerable to sudden reversal of capital flows.

In Kenya, more than half of its current account deficit is financed with short-term capital flows. Given the close links between such flows and domestic financial systems, the latter are vulnerable as well. So, although volatility of capital flows is a balance of payments issue in the first instance, what is particularly worrying from the perspective of this book is that it constitutes a critical source of instability for their financial systems. This can be true, for example, not just in terms of direct impacts due to currency mismatches of banks themselves, but also in terms of currency mismatches of companies. Where companies borrow from banks in foreign currency, but sell mainly in local currency, they are exposed to foreign exchange risk, which can indirectly also cause problems for the banks' stability.

If standard indicators, such as the capital adequacy ratios given above, show that financial systems are in good shape, there may however well be a problem with the indicators being used for financial stability assessment. These indicators should be broadened and measures should be undertaken to gradually reduce vulnerabilities.

As a contrasting example, Ethiopia may also have balance of payments' financing problems, but it is not resorting to easy foreign capital, due to the risks it creates. This at least keeps its financial system, still underdeveloped, insulated from external shocks.

Returning to the issue of a more diversified banking structure, there are important questions on the best composition of such a structure, as well as how it is achieved. African regulators envisage a diversified financial system, as mentioned above, but does this imply less (rather than more) consolidation? And if foreign banks are allowed in, thus contributing to a more diversified system, does it matter whether these banks are Pan-African or from developed countries? More broadly, do foreign banks contribute to financial stability or make countries more vulnerable to financial instability? Beck et al. (2014) summarizes the recent empirical

evidence well, by saying cross-border banking can help mitigate the impact of local financial shocks, but exacerbates global financial shocks.

In addition to the role that external capital had on Nigeria's banking crisis of 2009, the Nigeria chapter further suggests that in a LIC context a more consolidated banking system, which the country had attained prior to the crisis, does not necessarily make the system safer. Despite consolidation, Nigeria did not close down its development and specialized banking institutions. However, the past track record of these banks has been perceived as not good. Nevertheless, Nigeria has recently created new development financial institutions and mechanisms, which hopefully will be more efficient. As with the point made about development banks above, it may not be the precise form that a financial institution takes that is most important, but whether it operates effectively and efficiently with appropriate safeguards against excessive bureaucracy and/or capture by corrupt practices. Important lessons can be learned here from successful development banks in both developed and developing economies. The ideal may be a diversified system, but only if the components of this system operate effectively.

A lesson from Nigeria's recent experience is that what a natural resource rich country like Nigeria needs to achieve may not just be more or less consolidation, or more or less development banking. No approach is likely to succeed without institutional mechanisms that are more accountable and better governed so that natural resources wealth can be effectively channeled to support pro-poor and pro-growth projects.

Though development banks, as well as sovereign wealth funds, may play an important positive role, especially in channeling resources into long-term and strategic private and public investment for structural transformation, it is important they are well designed and well run. It is also important they complement, as well as work with, private banks and capital markets, where these function well, and do not attempt to substitute them. On this point, the Ethiopian chapter reflects some concerns about public banks excessively drawing on resources from private banks, even though it seems the public development bank does seem to channel its' resources efficiently towards long-term structural transformation.

Interviews conducted in the context of the research project that resulted in this book point to divergent views on whether foreign banks from developed countries or Pan-African banks are preferable.[5] Although foreign banks are currently not permitted to operate, Ethiopian regulators would give preference to those from developed countries if this were to change. These are seen as stronger, better managed, and subject to better regulation and supervision. They are often large and have more capital. If they came to Ethiopia, they would need to comply with the high national capital requirements shown above.

Regulators from other African countries express a different opinion. For them, banks from developed countries would just be more of the same: acting conservatively and following a banking model already practiced by the established foreign banks in their countries. In contrast, they believe that Pan-African banks would lend more, and cheaper, as has been reportedly already the case in Kenya, Tanzania, Uganda, Rwanda and other African countries where these banks have a presence. The lower spreads charged in the East African Community countries by pan-African banks (both in their home and host countries) than either foreign banks from outside the region or domestic private banks is confirmed empirically by evidence provided by the World Bank (2013) in the Financial sector Assessment Program led by World Bank (see

[5] These interviews were coducted in February 2015 and are reported in Gottschalk (2015).

also Beck et al, 2014). It should be noted, however, that even the relatively lower spreads reported charged by the EAC cross-border banks are still high, at an average of almost 12% for 2012.

The Ghana chapter, in contrast, suggests that the presence of Pan-African banks may generate important cross-border risks at the regional level, which their regulatory framework is not equipped to deal with. It also makes the point that regional colleges of supervisors, discussed further below, are good for information sharing, but not very useful for addressing crisis resolution problems, which would arise in case of failure of a Pan-African bank. The Nigerian chapter, moreover, alerts to the fact that supervision of operations of Nigerian banks with branches and subsidiaries abroad has been largely deficient so far, which poses risks both for Nigeria as a home country of several Pan-African banks and for countries hosting such banks.

## 3. Regulatory challenges facing African countries

The book chapters and the country studies, in particular, show that African regulators are investing time and resources to be fully compliant with the Basel Core Principles, and are submitting their banks to strict capital adequacy requirements. Some countries are still firmly under Basel I, while others are moving to Basel II and III.

However, despite their efforts and recent achievements in terms of having a good regulatory framework in place, and being up to date with recent international regulatory developments, all LIC regulators see it as a challenge to adopt financial standards designed internationally. The first reason has to do with their complexity. Indeed, even in developed economies, there are influential voices, such as that of Andy Haldane, Chief Economist at the Bank of England, who have persuasively argued that excessive complexity of regulation seems undesirable. Second, they lack sufficient capacity (human, technical) to do so. In the face of this challenge, their response has been, first, to adopt a gradual approach and, second, be selective, going for parts of regulation that are appropriate to their needs and the features of their financial systems. The country studies confirm this has been the case. Second, they are investing heavily in capacity building on a continuous basis, and for that purpose they are allocating the resources needed to support this investment.

In relation to Basel rules, which arguably are the part of banking regulation that is particularly complex and whose complexity has only increased, all countries are adopting a gradual approach. Kenya, for instance, fully complies with Basel I and with Pillar 1 on credit risk of Basel II. It is considering what aspects of Basel III they want to adopt, coordinating with its neighbors.

Systemic risks have been part of their regulatory concerns. Some countries are considering adopting some aspects of Basel III, in order to address systemic risks relating to bank size and pro-cyclicality of credit. Risks of loans to a single borrower are an older issue facing African regulators, for which they have in place quantity limits. Finally, African regulators have quantity limits to address currency mismatches, which can create important risks for countries with open capital accounts. This is positive, but as pointed out above, indirect effects of such currency mismatches (on the companies to whom banks lend), need to be also considered by regulators.

Despite all their efforts, African regulators may need to do more to address adequately systemic risks. Their focus has traditionally been on micro-prudential rather than macro-prudential regulation. Although these measures are important, they might give regulators a false sense of safety. It is encouraging regulators acknowledge in interviews that it is important to develop more regulation of systemic risks.

What might be needed is a more robust analysis and understanding of the links between the macro-economy and the financial sector. Counter-cyclical (or macro-prudential) regulation is one concrete way in which these links can be established. It is an important innovation of Basel III, that should be adopted in low- income countries, though its features would need to be adjusted to the needs and features of their financial systems.

A step forward in this area might not be just in the form of more investment on regulatory capacity in a narrow sense. Instead, what seems needed is to approach these risks differently. The safety of a country's financial system should not be just the responsibility of regulators, but of other government officials as well, so that issues arising from macro-financial links can be quickly spotted, understood and adequately addressed. In their efforts to build capacity, African countries need new and different skills to be able to keep up with the regulatory developments and to have effective regulation and supervision in place.

**Main policy conclusions and research challenges**

Clearly there is not enough finance to support inclusive growth in LICs. It is not just the quantity of finance that matters, but its maturity and cost. The quantity *and* the quality of finance in LICs are both problematic. There is insufficient finance, and that which is available tends to be short term, expensive, and not well suited to the needs of borrowers. This is especially true for small and medium enterprises, “the missing middle”.

An area of focus of this project has been the cost of loans, which remains high in many LICs. This restrains growth and fosters financial instability. Solutions have proved elusive. Numerous reforms to increase competitive pressure and efficiency in the banking sector have had little impact upon spreads. Identifying and addressing the determinants of reducing the cost of finance, for individuals and firms in LICs, including through greater transparency and possible regulation, such as capping interest rates is a crucial area of future research.

The structure of the banking sector is important. A first feature should be that the financial sector should be simpler, in the sense that, for example, the type of instruments used should not be complex or opaque, and thus the risks could be more easily assessed by the institutions themselves, and by the regulators. This facilitates regulation itself to be simpler. Furthermore, simple arrangements and institutions that increase and share information, like credit bureau, can play a very positive role to both increase access to credit and to enhance financial stability.

Evidence suggests that a diverse set of banking institutions would improve both the quantity and quality of finance for different borrowers, and thus have positive impacts on inclusive growth and stability. As regards the latter, the benefits of diversification for reducing risk is well known, within institutions, but should also be applied across institutions. Further research and policy discussion seems needed for the desirable composition of the financial system in LICs, for example the balance between public and private banks, large and small institutions, domestic and foreign, and between more universal banks and those focused on particular sectors such as SMEs.

While the potential for development banks to foster inclusive growth in LICs is significant, there are some risks. Our understanding of how to design and run 'good' development banks that can fulfill this potential while avoiding risks is growing, but remains at an early stage. The need for development banks is not new, but new challenges and what we have learned about successful development banks make this a new area of research in development finance. Focusing on LICs, where the need for development banks seems large, but the risks they create may also be large, seems a particularly important area of research.

Regulation is fundamental. If we know more about the types of financial institutions that are best suited to balancing inclusive growth and stability in LICs, it is necessary to design regulatory frameworks and other measures to encourage/support the emergence of these institutions. A second issue is how different types of institutions should be regulated and supervised in LICs. The benefit of a diverse set of finance institutions is that they can offer different services to different groups of customers. It is important that regulation is designed to support – rather than stifle – the services different financial institutions can provide. Furthermore, though regulation may be diverse, it should be equivalent, to avoid regulatory arbitrage. It should also be comprehensive, so all financial institutions providing credit are regulated, but such regulation should be proportional to the level of systemic risk different financial institutions are likely to generate.

A diverse mix of heterogeneous institutions is very unlikely to evolve naturally, or to survive if it does so. Understanding how regulation can help support and maintain this process in LICs is another new area of research.

Macro-prudential regulation is an important area for regulation that has been mainstreamed since the global financial crisis. It requires better understanding on how domestic regulation interacts with the macro-economic and external environment in a LIC setting, including which tools are most appropriate (whether for example focusing on domestic financial regulation or managing the capital account) to deal with this interaction such that stable, inclusive growth is supported.

Simply importing frameworks from developed and emerging countries, such as Basel 2-3, is not the solution. If LICs are to use financial regulation to help strike the right balance between growth and stability, this will need to be designed explicitly for the circumstances of low-income countries. Again, more research is required.

We have focused more on the banking sector; however, capital market development, especially local currency bond market development is also an important area, both for policy and research.

Financial sector development is crucial for inclusive growth in LICs. However, financial instability can have devastating consequences, especially for poor people. How finance can help achieve the optimal balance between growth and stability in LICs, and the role that regulation should play in this, is among the most pressing development questions policy-makers and researchers face. We hope to have contributed to an understanding of these issues with this book, by providing some answers, but many more questions.

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