

Growth Research Programme

Sustaining growth and structural transformation in Africa: how can a stable and efficient financial sector help?

Current policy and research debates

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Sustaining growth and structural transformation in Africa: how can a stable and efficient financial sector help?

DEGRP Policy Essays aim to bring together the latest thinking on growth policy in low-income countries from leading researchers and decision-makers around the globe.

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Executive Summary

The DFID-ESRC Growth Research Programme (DEGRP) produces a range of knowledge products which link the research of DEGRP to a number of research and policy debates on the following themes: *agriculture; financial markets; and innovation and growth*. The theme of structural transformation is the basis of much of the programme's work; the concept involves productivity change through broad-based shifts in employment across sectors. This paper relates to the financial markets theme and draws together a number of essays that emerged from a public debate in Ghana on '**What does it take to build a stable and efficient financial sector for sustaining growth and structural transformation in Africa?**'

The lead speaker, **Governor Wampah of the Central Bank of Ghana** argued that by enabling greater diversification, risk sharing and investment in higher productivity activities, financial development can facilitate resource allocation and therefore, economic transformation. **Efforts to develop the financial sector, according to him, should focus on enhancing depth, access, efficiency and stability. He argues that financial sector support to the real sector remains weak in many African countries**, with corporate lending at the short end. **There is also a lack of adequate competition**, with an oligopolistic banking sector, leading to inefficient pricing of financial assets. He concluded that building a sound, stable and efficient financial sector is indispensable for sustained economic growth and structural transformation.

This set of essays is structured into four parts: (i) **background**, (ii) **experiences in three African countries: Ghana, Kenya and Nigeria**, (iii) **lessons from India, China, Japan and other Asian countries**, and (iv) **future research agenda**.

DEGRP has initiated or re-emphasised a number of important debates on what features of financial sector development are conducive to low-income countries (LICs) to structurally transform their economies:

- **Financial markets and structural transformation: What is the appropriate depth, size and growth of the financial market for structural transformation? What is the optimal level of credit for the private sector and how can this be achieved (Beck)?** In African countries it is often low (Mwega), but there are concerns about increases that could be too fast, and thus endanger financial stability (Spratt, Griffith-Jones).

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- **Cost vs efficiency:** How can the costs of finance be minimised and efficiency of banking and financial markets be enhanced? Both the policy rate and the spread in lending rate are high in African countries, and especially Ghana, so there are **questions about the structure, conduct and performance of the banking sector** (Ackah).
- **Long-term finance:** What mechanisms can ensure the availability of long-term finance (Wampah)? **Can this be left to the market, or do we need development banks** (Hosono) or similar co-ordinating institutions that match supply and demand? When and under what pre-conditions do they work, so we have good development banks or other public mechanisms?
- **The missing middle:** What structure and level of regulation is required for the financial sector to promote access and financial inclusion? It is typical in African countries to have a range of large, foreign banks (including intra-African ones) servicing multinationals and buying government bonds, micro finance institutions for small firms, but no or little finance for small and middle sized enterprises, e.g. for the missing middle (Ajakaiye and Shreffdeen; Wampah).
- **Capital flows:** What is the desirability of different types of capital flows? Structural transformation has large financing needs, but what is the role of different international capital flows in funding growth, and how can they be regulated so they do not undermine macroeconomic stability (Thorat, Massa and Gottschalk)?

1. Introduction

Dirk Willem te Velde, Overseas Development Institute (ODI)

The DFID-ESRC Growth Research Programme (DEGRP) funds world-class scientific research on issues relating to economic growth in low-income countries (LICs), with high potential for impact on policy and practice. In addition, the programme aims to ensure that evidence is used to develop the capacity to undertake and use research in developing countries, and has an impact on growth policy. DEGRP produces a range of knowledge products aimed at linking the research of the programme to a number of research and policy debates on the following themes: agriculture; financial markets; and innovation and growth.

The theme of structural transformation is the basis of much of DEGRP's work; the concept implies productivity change, involves sectoral shifts and is broad-based involving employment generation. A strategy is needed to achieve it. This involves addressing many market and governance failures. The programme is interested, for example, in examining what policies/institutions can help structural transformation and productivity change¹. **In this set of essays we specifically explore what financial structures and regulations are required for structural transformation and growth.**

The origin of this publication lies in the public debate that DEGRP organised in co-ordination with the Institute of Statistical, Social and Economic Research (ISSER) and a DEGRP project led at ODI by Professor Stephany Griffith-Jones on financial regulation and inclusive growth. The debate, 'What does it take to build a stable and efficient financial sector for sustaining growth and structural transformation in Africa?' included a key note speech by the Governor of the Central Bank of Ghana, Dr Henry Wampah. The Governor's speech is published in this paper. The Governor addressed a range of issues: he argues that by enabling greater diversification, risk sharing and investment in higher productivity activities, financial development can facilitate resource allocation and hence, economic transformation. Efforts to develop the financial sector, according to him, should focus on enhancing depth, access, efficiency and stability. He further argues that financial sector support to the real sector remains weak in many African countries, with corporate lending at the short end, and that there is a lack of adequate competition, with an oligopolistic banking sector, leading to inefficient pricing of financial assets. He concludes that building a sound, stable and efficient financial sector is indispensable for sustained economic growth and structural transformation.

The rest of the essays are structured in four parts: the first three essays in part 1 provide background to the topic and summarise longer background papers. Stephen Spratt summarises the main findings from

¹ See te Velde, D. (2013) *Innovation and productivity change in low-income countries*, DEGRP Overview Paper. <http://bit.ly/1cPnrAs>

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a systematic review on the effects of financial regulation on growth and financial stability. He argues that financial sector development is critical for sustainable growth in LICs and reviews a number of questions relating to government interactions with the financial system, access to finance, private sector credit from banks, and the structure of the non-bank financial sector. Ricardo Gottschalk discusses the challenges of implementing financial regulation in sub-Saharan Africa, suggesting the need to examine the issues of implementation from the point of view of African regulators. Isabella Massa discusses the challenges in capital account management, and how various capital flows can be managed. She distinguishes between different types of capital, arguing that portfolio flows and short-term debt are more volatile than other capital flows.

Part 2 discusses the experiences in three African countries: Ghana, Kenya and Nigeria. Charles Ackah highlights competition, efficiency and the interest rate spread in Ghanaian banking. He finds that the interest rate spread is comparatively higher than in other African countries, arguing that this is either due to the structure, or the conduct, of banking. Francis Mwegu discusses the financial sector in Kenya and makes the point that efficiency of the financial sector has increased, although further solutions are suggested, such as improving the collateral process, credit information and other targeted interventions. He suggests that the size of the financial sector is not beyond the threshold that would negatively affect economic growth. While one-third of the population is still without access to financial services, there has been considerable progress, especially through mobile money financial services. Olu Ayakaiye and Sheriffdeen Tella discuss the experience of the 2004 banking sector reforms in Nigeria. The reforms resulted in the emergence of mega banks serving large corporates (responsible for increases in private sector credit to GDP ratios) rather than financing small and medium enterprises (SMEs), resulting in a lack of real sector financing. They argue that SMEs are now at a serious disadvantage, despite financial reforms and regulations over the years.

The third section presents international experience and lessons from India, China and Japan. Usha Thorat describes the lessons from the Indian experience of financial liberalisation starting in 1991 as:

- (i) the costs of excessive regulation and the need to benefit from more competition,
- (ii) as an economy liberalises it is open to higher risk and need for sound macroeconomic fundamentals,
- (iii) India's approach to reforms was guided by (a) cautious sequencing of reform measures, (b) the introduction of mutually reinforcing norms, (c) initiating complementary reforms across sectors, (d) development of financial institutions, and (e) growth and integration of financial markets,
- (iv) liberalisation of the domestic financial sector which preceded capital account liberalisation has benefited the economy,
- (v) in liberalising the external account, India has been extremely cautious. Equity flows have been encouraged, debt flows are considered more volatile and have been subject to controls,
- (vi) a central bank and regulator must be sensitive to markets, but not capitulate to them,
- and (vii) there is a need to take the right lessons from crises.

Helmut Reisen and Christina Wolf discuss Chinese development finance in Africa. They argue that the Chinese mode of engagement forces raw-material-rich countries to invest at least some of their revenues

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into projects that are beneficial to the country as a whole. Hence, China may contribute to turning raw material richness into a boon rather than a curse for people in sub-Saharan Africa.

Akio Hosono examines the experience of development finance from an Asian experience and identifies the following lessons:

- (i) industrialisation and economic transformation were essential for inclusive development, especially for generating 'good' jobs,
- (ii) in Far East Asian countries, policy-based financial institutions not only provided low-interest loans for economic transformation and inclusive development, but were instrumental in preventing disorder in the finance sector,
- (iii) in Far East Asia, government commitment made it easier to invest in new industries. In ASEAN countries, large industries were financed by foreign direct investment (FDI) and related external finance, while SMEs and agriculture were generally financed by public financial institutions and local commercial banks.

Two essays make up the final section and discuss the future research agenda. Thorsten Beck argues that research is required to find the 'Goldilocks level of financial development'. He claims that the financial system can be too cold and too hot. The question then becomes, which policies and interventions would lead to a financial system that is 'just right'? The concept of the financial possibility frontier can serve as a framework to identify bottlenecks in a country's process of financial deepening and different policy areas to overcome them. It can also serve as a basis to discuss the role of different segments of the financial system (banks, capital markets, contractual savings institutions, low-end financial institutions), their development and importance as countries' financial systems develop, and their impact on growth.

Stephany Griffith-Jones discusses the questions of her DEGRP research project on 'Financial regulation in low-income countries: balancing inclusive growth with financial stability'. This focuses on:

- identifying key national risks to financial stability as well as gaps in the financial sector for funding inclusive growth,
- regulatory measures to support financial stability,
- management of the capital account,
- and advantages and problems of different mechanisms for such regulation, given country characteristics (weak institutions, information problems).

It has identified a number of research questions in relation to: (i) lack of access and high cost of credit, especially for SMEs, (ii) the sort of financial system that is needed to seize growth opportunities, (iii) the desirable scale and growth of the financial sector, and (iv) the importance of implementing Basel II/III for ensuring financial stability.

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DEGRP initiated or re-emphasised a number of important debates (which were carried further into the African media²) on features of financial sector development that are conducive to structural transformation in LICs:

- What is the appropriate depth, size and growth of the financial market for structural transformation? What is an optimal level of credit for the private sector and how can this be achieved (Beck)? In African countries, it is often low (Mwega), but there are concerns about increases that would be too fast (Spratt, Griffith-Jones).
- How can the costs of finance be minimised and efficiency of financial markets be enhanced? Both the policy rate and the spread in lending rate are high in African countries, especially Ghana, so there are questions about the structure, conduct and performance of the banking sector (Ackah) and the incentives for banks to lower their administration costs, innovate and reduce profit margins. Can the high costs of finance impede investment, innovation and the possibility of structural transformation?
- What mechanisms can ensure the availability of long-term finance (Wampah)? Can this be left to the market, or do we need development banks (Hosono) or similar co-ordinating institutions that match supply and demand? When do they work?
- What structure and level of regulation is required for the financial sector to promote access and financial inclusion? It is typical in African countries to have a range of large, foreign banks servicing multinationals and buying government bonds, micro finance institutions for small firms, but no real sector finance, e.g. for the missing middle (Ajakaiye and Shreiffdeen; Wampah).
- What is the desirability of different types of capital flows? Structural transformation has large financing needs, but what is the role of different international capital flows and how can they be regulated (Thorat, Massa and Gottschalk)?

² See http://storify.com/degrp_growth/degrp-and-issers-financial-sector-debate-accra-ghan

2. 'What does it take to build a stable and efficient financial sector for sustaining growth and structural transformation in Africa?'³

H.A.K. Wampah, Governor of the Central Bank of Ghana

Public panel discussion, 11 September 2013, Isser Conference Hall, University of Ghana

Mr. Chairman and Vice Chancellor, University of Ghana, excellencies and fellow panellists distinguished guests, ladies and gentlemen:

I would like to thank ISSER and the DFID-ESRC Growth Research Programme (DEGRP) for inviting me to speak at this function. I am indeed happy to contribute to such an important discussion on sustaining growth and structural transformation in Africa. I would also like to thank the panellists for taking time to be here, to participate in this important discourse. I have been asked to speak on the topic, '**What does it take to build a stable and efficient financial sector for sustaining growth and structural transformation in Africa?**' Although there are obviously many issues to be discussed under such a topic, let me say from the outset that building a sound, stable and efficient financial sector is critical for sustaining growth and structural transformation in our economies.

The need for sustained or long term growth and structural transformation has dominated the intellectual discourse as well as policy debates for years, and has become even more urgent and pervasive across the world in recent times. All countries, both rich and poor will need to pursue economic, social and environmental transformations at some stage along the way. For example, while high-income countries seek to change their consumption and production patterns and invest in human capital formation to maintain their living standards, developing countries need to promote structural transformations to meet the aspirations of their people for sustained growth with equity and development.

Generally, structural transformation involves the reallocation of economic activity from low to high productive sectors, and this is aptly illustrated in the literature on economic development (by Chenery, Kuznets and Lewis) as shifts of output and labour move from agriculture to manufacturing, followed by manufacturing to services at later stages of development. This pattern is consistent with the experiences of advanced economies that saw secular declines in manufacturing employment and sectoral value added since the 1970s. It is also consistent with the economic development experience of the 'Asian Tigers' namely, Hong Kong, Indonesia, Malaysia, Singapore, South Korea and Thailand, who experienced dramatic changes over the last five decades.

³ This speech has been adapted from the original speech given on 11 September 2013

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Their economies have fundamentally changed from traditional agriculture-based societies to rapidly growing newly industrialised nations, as sustained high rates of economic growth were accompanied by significant structural changes. In other emerging market economies (EMEs) and low-income countries (LICs), sustaining long-term growth with structural transformation remains a policy challenge. How to accelerate economic transformation and catch up with higher income levels remains a policy imperative.

While there appears to be consensus in the intellectual as well as policy circles regarding this traditional pattern of sustained growth with structural transformation, the experience is that the pace and pattern have, in more recent times, tended to vary across countries. For instance, it is a fact that the recent high-growth episodes in many of our countries in sub-Saharan Africa have been mainly driven by the exploitation of extractive natural resources and growth in services, while the share of agriculture in output has declined and the manufacturing sector's share of output has remained broadly unchanged. Similarly, while the striking growth performance of East Asia was underpinned by dynamism in manufacturing, economic growth and structural transformation in other emerging market countries has been uneven.

These observations about relative differences in patterns across countries and regions underscore the view by a section of the literature that there could be specific factors driving such patterns of structural change across countries, such as differences in policy, institutional and reform frameworks. Generally, the factors identified include a large number of macroeconomic and structural variables. For example, larger trade flows and trade liberalisation policies are said to drive changes in the output structure of many emerging market economies. Also, openness to international trade can facilitate technology transfer and contribute to efficiencies in production.

The degree of financial sector development and human capital formation are also cited, and this is my focus in this lecture. It is argued that by enabling greater diversification, risk sharing and investment in higher productivity activities, financial development can facilitate resource allocation and hence, economic transformation.

I will now focus my talk on the role of the financial sector in driving sustained economic growth and structural transformation in Africa. By definition, the financial sector includes the set of institutions, instruments and markets, as well as the legal and regulatory framework that permit transactions to be made through the extension of credit in the economy.

Broadly speaking, financial sector development is about working to reduce 'costs' such as costs of acquiring information, enforcing contracts and executing transactions in the economy. This results in the emergence of financial contracts, intermediaries and markets, as different types and combinations of information, transaction and enforcement costs tend to exist in line with different regulatory, legal and tax systems.

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There is no question about the fact that an efficient financial sector provides the rudiments for income-growth and job creation, and therefore plays a significant role in economic development. It promotes economic growth through capital accumulation and technological advancement by boosting the savings rate, delivering information about investment, optimising the allocation of capital, mobilising and pooling savings and facilitating and encouraging foreign capital inflows. There is also conclusive evidence suggesting that countries with better-developed financial systems tend to enjoy a sustained period of growth and development. Additionally, financial development contributes to a reduction in poverty and inequality by enabling and broadening access for the poor and vulnerable to shocks, and raising investment and productivity that generates higher income.

Financial sector development is however like a two-edged sword, cutting in both directions. It requires robust financial policies and regulatory frameworks, because the absence of these could have disastrous outcomes, as observed during the recent global financial and economic crises. When the financial sector functions well, it will have significant positive impact on economic development, while a malfunctioning one would no doubt have a negative impact on the economy.

What is clear is that efforts to develop the financial sector should focus on enhancing depth, access, efficiency and stability. These have underscored efforts in many of our countries to build a sound, safe and stable financial sector. You will recall that several African countries undertook extensive restructuring and transformation of their financial sectors. From the first generation set of reforms that began in the mid-1980s, many countries implemented policy reforms that liberalised interest rates and removed quantitative restrictions on credit provision. Barriers to entry and exit were also lifted, and state-owned banks were privatised.

Subsequently, to address structural and institutional challenges in the sector, focus was shifted to strengthening financial infrastructure, especially regulatory frameworks, including the supervisory capacity of the banking system and affirming Central Bank independence. Recent reforms have placed emphasis on corporate governance issues, including enhancing transparency and accountability, improved information and disclosure requirements, investor education and promotion of better accounting and auditing standards in line with international practices.

Generally, these reforms have yielded significant results in most countries in Africa, as financial depth, access, efficiency and stability have improved to an appreciable extent. Credit ceilings and directed credit have been eliminated and interest rates liberalised. The banking systems have improved with stronger balance sheets and capital bases, while risk management has been enhanced with some relative growth in capital markets across the continent.

Notwithstanding, challenges have remained and financial sector support to the real sector remains weak. Corporate lending is still, in many cases, focused on the short end of the market and few banks engage in long-term lending, while bank balance sheets tend to be dominated by short-term deposits. There is also a lack of adequate competition, as the banking sector remains in many cases, oligopolistic,

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leading to inefficient pricing of financial assets. The increasing regionalisation of banks has also brought cross-border challenges that require appropriate regulatory frameworks.

In Ghana's case, our financial sector has also undergone comprehensive restructuring and transformation since the implementation of the Financial Sector Adjustment Programs (FINSAP I and II) from the late 1980s through to the late 1990s. The implementation of FINSAP I and II focused on liberalisation of interest rates and abolition of directed credit, restructuring of financially distressed banks, strengthening of the regulatory and supervisory framework, and the promotion of non-bank financial institutions. It also focused on liberalisation of the foreign exchange market and establishment of the Ghana stock exchange to develop the capital markets industry.

From 2001, a new Financial Sector Strategic Plan (FINSSP) was introduced. Among the reform measures under this plan were the promulgation of a new Bank of Ghana Act 2002 and the establishment of a new monetary policy process. The plan also emphasised promotion of long-term savings and venture capital, payments system development and the establishment of a collateral registry. Several financial sector legislations were revised, including the Foreign Exchange Act 2006, Anti-Money Laundering Act 2008, the Credit Reporting Act 2008, Borrowers and Lenders Act 2008, Insolvency Act 2003, Home Finance Act 2008, Non-Bank Financial Institutions Act 2008, Central Securities Depository Act 2007, Insurance Act 2006 (Act 724), and National Pensions Act 2008.

Payment and settlement system reforms were pursued with the introduction of a Real Time Gross Settlement System (RTGS), Central Securities Depository (CSD), Automated Clearing House (ACH), and a system for Cheque Codeline Clearing (CCC). A national payment system with a common interoperable platform that is inclusive of the unbanked in rural and urban areas (e-zwich) was also introduced, and the regulatory and supervisory framework was further strengthened with emphasis on risk-based supervision and electronic financial analysis and surveillance.

Our recent assessment of Ghana's banking sector as at July 2013 suggested that the banking sector remained profitable, liquid and well-capitalised. Capital Adequacy Ratio (CAR) for the industry as at July 2013 was about 18%, beyond the prudential limit of 10%. Asset penetration, measured as the ratio of total assets to GDP, was 40.5%, indicating continued deepening of the financial sector in the economy. The industry NPL has also declined gradually to 12.8% (4.7% excluding loss category).

The Bank of Ghana recently implemented a key measure to enhance transparency in pricing of loans in the industry. A new base rate model that seeks to ensure transparency and uniformity within the banking industry was introduced in July this year. So far, all banks have fully complied with the new framework, and this has led to a decline in average base rates by about 3% across the banking industry. The new initiative, together with the credit bureau system and the operationalisation of the collateral registry will help address the problem of information asymmetry in credit delivery, and thereby lower NPLs across the banking industry and reduce the cost of credit.

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The Bank of Ghana has also taken steps to review the minimum capital requirements for new banking industry entrants. These increases in the minimum capital will ensure that banks are able to undertake big-ticket deals to support the growth of the private sector in the transformation of the economy. This is critical for risk management purposes, as banks would have adequate capital to absorb unexpected losses.

In a bid to further protect the interests of depositors and shareholders in the banking industry, a standard Supervisory Intervention Guide is being developed. This guide seeks to ensure a consistent and transparent framework for intervention in the operations of regulated deposit-taking Financial Institutions as and when necessary. This is being complemented by efforts to establish a deposit insurance scheme, which is expected to become operational by December 2014. In addition, the bank is taking steps to further strengthen the regulatory and supervisory regime, by revising and consolidating existing industry laws and introducing other guidelines such as Corporate Governance Regulations, Licensing Regulations, Outsourcing Guidelines, Risk Management Guidelines, External Auditors Regulations, and Mergers and Acquisition Guidelines.

It is our expectation that these initiatives would address potential vulnerabilities and ensure a safe and sound banking industry in Ghana.

One key challenge going forward, however, is to do with maintaining the pace of progress over the medium-to-long term, as macroeconomic stability gets anchored and interest rates decline further. Banks will have to continually review their risk management systems and explore new avenues to maintain the bottom line with emphasis on cost rationalisation and growing other areas of income. Players in the industry will also have to embrace the challenge of reaching out to start-ups and small and medium enterprises (SMEs), to grow new businesses that would sustain their balance sheets in the long term.

Even though this segment of borrowers has often been perceived to be risky, the role of small and medium enterprises in the economy cannot be over-emphasised. It is documented that SMEs tend to serve as catalysts for economic growth, employment and poverty reduction. Hence they play a critical role in sustaining long-term growth and economic transformation. Unfortunately, by their nature, SMEs often lack proper management systems, and have low technical knowledge and poor labour skills. They tend to have weak competencies in financial management and operate with low levels of productive capital which often reinforces the perception regarding their risk profiles.

These factors generally work against them in accessing financial services, especially through the traditional banking system. On the contrary, going beyond these constraints, the evidence suggests that financing SMEs can be good business in many cases. What is important is for banks to adequately understand the mode of operation of SMEs and to develop innovative financial services for them in line with their particular needs.

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To conclude, Mr. Chairman, let me emphasise again that building a sound, stable and efficient financial sector is indispensable for sustained economic growth and structural transformation. This is why reform efforts in the financial sector which have been ongoing for the past several years, remain key. Even though appreciable progress has been made since such reforms started in the early 1980s, in terms of depth, access, efficiency and stability in the financial system, there remain significant gaps in policy and institutional reform that must be addressed going forward. For example, addressing market failures is critical to ensure that financial resources reach critical areas and sectors of the economy. The area of pension reforms and the creation of appropriate legal and regulatory frameworks to facilitate long-term savings is also imperative.

There is a need to enhance technology and infrastructure for financial services delivery, to have strong and independent institutions for market regulation, and also to develop the necessary framework to protect consumers of financial services. Finally, we must continue to enhance the conduct and implementation of monetary policy, by constantly improving the framework for managing liquidity and deepening financial markets to improve the transmission and effectiveness of monetary policy actions.

Background

3. How does financial regulation in low-income countries affect growth and financial stability?

Stephen Spratt, Institute of Development Studies (IDS)

Without effective regulation, financial systems can become unstable, triggering crises that can devastate the real economy. The ongoing repercussions of the recent global financial crisis that began in 2007 show how large these effects can be. However, there is another side to regulation. The primary purpose of finance is to facilitate productive economic activity. The avoidance of crises creates the foundation for this, but does not guarantee it is done well: financial regulation has a profound effect on the ability of the financial system to perform this function.

The purpose of regulation is thus twofold: to maintain financial stability and to promote economic growth. This is a delicate balancing act, as too great a focus on stability could stifle growth, while a headlong dash for growth is likely to sow the seeds of future crises.

It is often said that regulatory norms cannot simply be taken from developed economies and transplanted to low-income countries (LICs). In practice, however, this is often what happens, despite the fact that the structures of LICs' real and financial sectors are very different. Consequently, the financial regulation needed to maximise growth while maintaining stability should also be very different. The global financial crisis needs to be taken into account in this regard. Since 2007, the regulatory practices of the major financial centres can no longer be seen as the model to which developing countries should aspire. As regulatory options are being reassessed in developed economies, the time is therefore ripe to do the same in developing countries in general, and LICs in particular.

It was in this context that I recently completed a large-scale review of evidence¹ on the question posed in the title of this essay. At the outset, the different ways that regulation could impact on growth and stability were identified. There were two parts to this: first, by influencing the day-to-day behaviour of

¹ This essay is based on upcoming results from a systematic review undertaken as part of the DEGRP Project 'Financial regulations in low income countries' to be published (forthcoming). It was also presented at the ESRC/DFID workshop on 'Financial Regulation in Low-Income Countries: Balancing Inclusive Growth with Financial Stability' in Accra Ghana in September 2013.

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financial market actors, regulation has direct effects – how much a bank chooses to lend to small and medium enterprises (SMEs), for example. Second, regulation influences how the financial system evolves structurally, creating indirect effects – the diversity of the banking system, for example, will influence the pattern of lending by sector.

The next stage of the review identified four channels of direct and indirect impact. In each case, a series of research questions was identified. Evidence on these questions was then gathered from an extensive review of literature, with a little over one thousand papers being considered potentially relevant and of sufficient quality. The first finding is that LIC-specific evidence is limited. Most research looks at developing countries as a group, or at high- or middle-income countries. Only a small proportion examines LICs exclusively.

The first impact channel to be reviewed was government interaction with the financial system, particularly how domestic and external borrowing might affect growth and stability. On the domestic side, the key issue is the potential ‘crowding out’ of the private sector by excessive government borrowing. In some respects, this may be less of a problem in LICs, as the availability of concessional finance provides an alternative source of finance. On the other hand, lack of integration in the global financial system reduces the alternatives available to private borrowers, potentially making the problem worse. Surprisingly, there is little evidence to draw upon on this question, which is an important area of future research.

For external borrowing, previous orthodoxies of what is sustainable are now being questioned. The impact of the global financial crisis on borrowing levels in developed countries, the questioning of key evidence on sustainable debt thresholds, and changes to the stability and economic prospects of many LICs, have all called into question notions of ‘debt intolerance’. In light of these changes, there is now a good case for revisiting the LIC debt-sustainability frameworks used by the Bretton-Woods Institutions².

The second channel looked at access to finance, where the key problem is how to provide financial access that is both affordable and suited to the needs of poor people. On this, the costs of providing basic banking services are often prohibitive, and credit is either unavailable or too expensive. The reasons are well understood: providing physical access in rural areas is inherently expensive, and providing financial services for people with few financial resources entails high relative costs; a lack of credit history and collateral is a key constraint on extending credit, and small loan sizes also mean high transaction costs. Extending financial access thus tends to be unattractive for banks in LICs.

Although microfinance institutions (MFIs) have partially filled this gap, their record is mixed. Some evidence questions the focus on providing credit, for example, which can worsen the situation by adding to debt levels. Extending the supply of affordable credit from other financial institutions requires a

² See <http://www.imf.org/external/np/exr/facts/jdsf.htm>

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significant increase in third party credit bureaux. More generally, we know little about which financial services are most important for poor people, and how these can be most effectively delivered at low cost. On the second question, the bundling of products has been shown to lower transaction costs, as have practices such as 'branchless' banking, where services are delivered through other institutions in rural areas.

Perhaps the most significant development is mobile banking, the rapid growth of which shows its ability to overcome problems of physical access and high relative costs. For regulation, the success of M-Pesa in Kenya is often used to argue for a light-touch approach, where mobile banking was allowed to flourish. Possible systemic and individual users' risks seem to require careful evaluation, however. It is clearly important to enable, rather than stifle, innovation but it is also clear that regulation should be comprehensive in the longer term. How to strike the right balance here is an important area of research.

The third, and most developmentally important, channel is private sector credit from banks. As well as private banks, the potential for public development banks was examined. We have long known that private banks will under supply long-term finance, and under serve key sectors, such as agriculture or small and medium enterprises (SMEs), and that these 'market failures' are more acute in LICs. Although development banks are an obvious solution, they were widely seen as inefficient, ineffective and corrupt – the 'cure' was thought worse than the 'disease'. This perception has shifted significantly since the recent financial crisis, where some countries with significant public development banks saw them fill the gap left by the private sector. Now the success of public banks in countries as diverse as Brazil, South Africa and Germany has shown it is possible to avoid many pitfalls. An urgent research question therefore is how to learn from these examples and design successful development banks in LICs.

For the private sector, a few large banks dominate in most LICs. These are often able to generate very high profits by lending to large 'blue-chip' corporations and government. As a result, they have few incentives to diversify into other sectors where profits may be lower and/or difficulties greater. Some argue that LICs are best served by a large number of small banks, each serving local areas which they understand well. Others propose a mix of large, medium and small banks. As well as size, there is a strong case for diversity of sector focus – SMEs or agriculture, for example. Finally, diversity in ownership, such as savings and credit co-operatives (SACCOs), also appears to have beneficial effects in many LICs.

There are many advantages to a diverse banking 'ecosystem'. First, diversity prevents banks all focusing on the most profitable customers, ignoring important parts of the economy. Second, as long as these institutions are 'overlapping' – for example, a small business could potentially raise finance from a SACCO, SME bank, MFI or commercial bank – competition should reduce borrowing costs. Very high borrowing costs are both a source of excess profits for commercial banks and a key constraint on development. They seem a particular problem in sub-Saharan LICs. Third, diversity and competition will also encourage the creation of financial products tailored to the needs of customers. Finally, the different loan portfolios that would result from this diversity are positive for stability, as shocks would

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affect individual institutions differently. Foreign banks are also part of this mix. While these can bring valuable skills, technology and capital, they can also bring risks. Evidence from the recent financial crisis showed that countries where foreign banks dominated the market could suffer negative lending shocks, as turmoil in the home markets caused parent banks to withdraw capital from the developing countries where they operated.

Key evidence gaps remain. Most importantly, research is needed on the optimal composition of the 'ecosystem' in LICs, including the ideal market share of foreign banks. Banking systems tend towards scale, concentration and homogeneity. We need to understand better how regulation can combat this, while maintaining a diverse banking architecture.

Turning to the regulation and supervision of finance more generally, there are three questions: who, what and how? For who; capacity constraints in LICs and the dominance of banking suggest a strong case for a unified approach with heavy central bank involvement. For the question of what institutions should be regulated and supervised, the answer is everything, but not in the same way: regulation should fit the size, complexity and systemic risk of institutions, but be light enough to encourage innovative business models. For the how – i.e. the tools that should be used – LIC regulators retain a relatively diverse 'toolkit' of instruments. Many can limit things like loan growth and concentration, or foreign currency borrowing and particular mismatches, or impose minimum liquidity or maximum leverage ratios. Instruments such as these have proved effective when used flexibly, particularly when compared to the more 'sophisticated' approaches developed in global financial centres.

More research is needed on how these 'toolkits' can be best used to balance growth with stability. Understandably, LIC regulators are determined to reduce the risk of banking crises. The danger, however, is that stability is achieved at the expense of growth. How to strike the right balance, within a framework that adjusts flexibly and rapidly, is a vital area of research.

A final issue is the implementation of Basel III, the international regulatory framework for banks. It is clear that the new Accord is not designed to suit LICs, and there is nothing to suggest that implementation would do much for financial stability. As well as furthering understanding of which elements are of potential value, research into a more LIC-compatible framework is important.

The issue of macro-prudential regulation at the system level has become prominent since the financial crisis. There is a rich literature for LICs to draw upon, particularly in relation to counter-cyclical regulation. While some suggest that LIC financial systems are not complex enough to require the macro-prudential approaches currently being debated in developed countries, maintaining system stability is arguably more important in LICs, due to higher volatility and potential for external financial shocks to destabilise economies. Further research is needed on which of the proposed macro-prudential tools could work best. In this regard, aligning domestic policy and capital account management is crucial.

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The final question reviewed was the optimal level and composition of the non-bank financial sector. On this, evidence of any kind is rare. Given limitations due to size and liquidity, stock markets are likely to remain peripheral in LICs. There is greater potential for private than public equity, where risk-sharing venture capital is needed, but is in short supply. There is also a good case for prioritising local bond market development, particularly for domestic currency. In each of these cases, upgrading areas such as creditor rights and contract enforcement are likely to yield significant wider economic benefits.

The final sector considered was insurance. Although tiny in LICs, interesting innovations can be seen in the micro-insurance sectors of some countries. These successes highlight an important point: although insurance tends to be the least developed financial sector in LICs, it may also be one of the most needed. Insurance protects against risk, and risks are often high in LICs, while the capacity to absorb shocks is low. An important final question, therefore, is: How can successful innovations be adapted and scaled up in LICs?

Although a very large quantity of research has been reviewed, many questions remain unanswered. We know that financial sector development is crucial for sustainable growth in LICs. We also know that financial instability can have devastating consequences. 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 we face, and will remain so for many years to come.

4. Challenges in implementing financial regulation in sub-Saharan Africa

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Despite having financial sectors that are relatively less integrated with the global financial system, Africa is not entirely insulated from financial globalisation, nor is it immune from its potentially destabilising effects, or from the challenges it creates for national financial regulators. Under financial globalisation, African low-income countries (LICs) face at least three inter-connected challenges concerning their financial systems: (1) whether and how to adopt complex regulatory approaches designed for developed financial systems, (2) how to address the challenges arising from the presence of foreign banks in their jurisdictions, and (3) how best to manage risks from a more integrated financial system with the rest of the world, as a result of capital account liberalisation (CAL).

Faced with these challenges, a critical issue is capacity for effective financial regulation and supervision. This takes us to the next question: how should capacity be assessed? Nowadays, developing country capacity is assessed in terms of ability to effectively implement and use standards of international best practice, but since the global financial crisis, a wave of criticism has emerged towards complex regulatory approaches for financial systems, and the need for simpler rules. These criticisms come from, among others, international regulators (Haldane and Madouros, 2012; Hoenig, 2012) who recently argued that complex rules are not only less effective, but can even be detrimental. The criticisms revolve around two main issues: the effectiveness of complex rules in helping avoid bank failures and financial crises, and the sheer scale of resources they require in terms of sophisticated risk assessment models, large databases and number of regulators in each jurisdiction. These criticisms are relevant for developed countries, but even more so for developing and especially low-income countries, which lack financial, technical and human resources to adopt these rules. Thus, in a sense, the benchmark for capacity assessment is being set too high and inappropriately. These countries can settle on simpler rules more in line with their specific needs, and it is in this light that capacity should be discussed.

African regulators themselves seem to be challenging the notion that they should aim for international regulation of best practice. A series of surveys by the Financial Stability Institute (FSI) done between 2006 and 2012 shows that they are downscaling their plans to adopt the most complex Basel rules, showing increasing preference for simpler rules.

³ Based on the paper 'Institutional Challenges for Effective Banking Regulation and Supervision in African LICs', presented at the ESRC/DFID workshop on 'Financial Regulation in Low-Income Countries: Balancing Inclusive Growth With Financial Stability', 10 September 2013, University of Ghana, Accra. This paper will be part of a longer paper for the project, which is forthcoming.

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Taking the related issues of regulatory challenges and capacity in this light, recent assessment by the IMF Financial Sector Assessment Program (FSAP), the World Bank Survey on bank regulation and supervision and a KPMG survey on African banking reveal a picture in which African countries seem to be making significant progress in acquiring capacity and resources, as well as gradually putting in place rules and tools for effective regulation and supervision. On capacity, IMF surveys show that technical capacity gaps exist in different areas, ranging from IT to data reviews and systematic risk evaluation, and that, although common across countries of different income categories, these gaps are more prevalent among LICs. Nevertheless, initiatives have been undertaken to fill these gaps, such as strengthening regulation and supervisory guidelines, expanding staff skills and risk management capacity, even though progress has been partial and uneven, with larger gaps remaining among LICs.

Resource availability, such as number and quality of supervisors and frequency of onsite supervision seems, in turn, to vary across countries significantly, with greater availability among countries with higher income per capita and bigger population size. On macro-prudential regulation, the World Bank survey indicates that virtually all African countries have rules in place to reduce systemic risks, such as limits on banks' ability to lend to a single borrower or to a group of related borrowers. They use a wide range of indicators to capture systemic risk, such as bank capital ratios, growth in bank credit, sectoral composition of bank loan portfolios, and foreign exchange position of banks. These rules and indicators appear in line with what African regulators (e.g. Bagyenda et al., 2011) believe are needed in Africa to address the sort of risks they face: volatility caused by external shocks, and thus the need for quantitative restrictions on the risk exposures of banks' asset portfolios, which are often affected by these shocks. Areas in which African countries are not doing so well relate to tools and regulations that Basel III highlights as important to address systemic risk. These include stress tests, tools to restrict large or inter-connected institutions, and counter-cyclical regulation to influence credit patterns. However, their appropriateness and usefulness are contested by African regulators (see for example Nigam, 2013).

Critical areas in which progress is needed are regulators' relationships with foreign banks in their jurisdictions, and risks associated with CAL. Banking systems in African LICs are often concentrated, and in many cases, foreign banks have a dominant presence. A key challenge is how to impose national rules on these banks when these rules do not conform to foreign banks' regulatory preferences; lack of cooperation between home and host supervisors, an issue detected in the IMF surveys, exacerbates the problems facing national regulators in this area. Finally, concerning risks associated with CAL, a key challenge is the ability for supervisors to monitor them. A key risk is currency mismatches, looking at the level of the economy as a whole, rather than just the level of the banking system. Thus, progress coexists with a number of remaining complex regulatory challenges. Above all, what is evident is a need to understand what the key issues and challenges are **in the opinion of African regulators**, and what, in their view, are the necessary actions required to improve banking regulation and supervision in their countries to ensure that their banks are robust and ready to fulfil their primary role: to support inclusive and sustainable growth.

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5. Challenges in capital account management in low-income countries

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Since the 1990s, the trend and composition of private capital flows directed to low-income countries (LICs) have changed quickly and significantly. In the early 1990s, LICs experienced massive inflows of private capital through a process of rapid financial sector liberalisation. Private flows collapsed after 1997, but started to recover in the early 2000s reaching peak values in 2007, before the global financial crisis hit. After a partial rebound in 2010, private capital flows declined again in 2011 due to the Euro zone crisis, but they are expected to have recovered in 2013. The composition of private capital flows to LICs has also changed rapidly. While in the 1970s and 1980s bank lending was the most important component of foreign capital, since the 1990s, foreign direct investment (FDI) and portfolio investment (equity and bond flows) became dominant. Over the last few years, bond flows in particular are becoming an increasingly important part of private capital flows in some sub-Saharan African LICs such as Kenya, Rwanda, Uganda, Tanzania and the Democratic Republic of the Congo (Stiglitz and Rashid, 2013; Hou et al., 2013; World Bank, 2013). The fact that their scale has increased so significantly in recent years is positive, but also may require caution for future borrowing to avoid accumulation of excessive debt.

Private capital flows are a double-edged sword for LICs. In some cases and under certain conditions, private capital flows may carry important growth opportunities. For example in the literature, several studies find that FDI may foster economic growth through capital formation, technology transfer and spillover, human capital enhancement, and increased competition (Toulaboe et al., 2009; Seetanah and Khadaroo, 2007, among others). However, the growth impact of FDI may be different across countries depending on their characteristics. FDI, for instance, appears to have stronger effects in non-fuel exporting countries as well as in economies with higher levels of financial sector development, more diversified economic structures, better infrastructure, stronger institutions, and greater macroeconomic stability (Dabla-Norris et al., 2010). The evidence on the growth-enhancing effect of other types of private capital flows is more mixed, but in some cases portfolio investment is found to foster growth in LICs with well-developed financial sectors (Choong et al., 2010), while cross-border bank lending is found to have a positive and significant growth impact in sub-Saharan African non-oil countries (Brambila-Macias et al., 2011).

On the other hand, private capital flows may increase LICs' exposure to three categories of risks: (1) macroeconomic risks, (2) financial stability risks, and (3) risk of capital flow reversal/sudden stop. The macroeconomic risks are associated with sudden surges in capital inflows, which can lead to

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appreciation and volatility of real exchange rates, as well as to inflation, thus affecting domestic policy objectives such as export promotion, exchange rate stability and national price stability. Financial stability risks refer to the adverse impacts that surges in capital inflows may have on asset prices and credit, thus leading to a higher incidence of financial crises. The risk of a capital flow reversal or sudden stop, instead, is associated with the composition of a country's capital flows (i.e. short-term loans and portfolio investment are more volatile and therefore have a higher potential for reversal or sudden stop than FDI). This may lead to depletion of reserves and sharp currency depreciations, as well as to currency crises that may be linked to banking crises.

Which are the tools that LICs may use to manage capital flows to exploit their growth opportunities, at the same time minimising their risks? In principle, there are three capital account management policy tools that may be implemented, each coming with its own advantages and disadvantages as described in detail in Massa (2013):

- capital controls, i.e. quantity-based capital controls or price-based capital controls;
- macroeconomic measures such as official foreign exchange intervention (sterilised or unsterilised), exchange rate intervention, and fiscal policy;
- structural measures such as prudential regulation and supervision (e.g. regulations on currency mismatches) and the easing of restrictions on capital outflows.

Nevertheless, it is very hard for LICs to identify which capital account management tools may work best in their economies for two main reasons. First, given LICs' country-specific characteristics, there are some issues that might arise in implementing certain capital account management tools, but not much attention has been devoted to these in the literature or policy arena. For example, sterilisation through the transfer of public-sector deposits from commercial banks to the central bank is difficult to implement in sub-Saharan African LICs where there is limited availability of eligible funds. Gupta et al. (2006) report that on average in sub-Saharan Africa, central government deposits in commercial banks amount to only about 2% of GDP. Fiscal tightening is also problematic to use in LICs as the need for social and infrastructure spending in these economies is extremely large (Deléchat et al., 2008; IMF, 2011). Moreover, the implementation of the developed country model of prudential regulation and supervision (the Basel Committee's Core Principles for Effective Banking Supervision) is particularly challenging in LICs as disclosure of financial information is inaccurate, skilled personnel are scarce and political interference in public administration is pervasive. The easing of restrictions on capital outflows is also problematic in LICs, characterised by a high level of capital flight, as if restrictions on capital outflows are eased it becomes easier to move funds abroad (Murinde, 2009). In a similar way, the use of capital controls in LICs with a high degree of capital flight is challenging as it may encourage the flight of capital through the development of mechanisms for circumvention of these regulations (e.g. over- and under-invoicing; disguising restricted flows as unrestricted flows; and derivative products) (Ndikumana et al., 2013).

Second, evidence on the types of capital account management tools that have been used in LICs over time, as well as on the effectiveness of such policy measures, is extremely limited and in some cases it is

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completely missing. This represents a severe constraint for policy-makers in LICs who cannot learn from previous capital account management experiences in peer countries. This is particularly worrying in relation to the use of capital controls and prudential regulation. Indeed, LICs account for the highest share of capital inflow and outflow controls among different country-income groups (IMF, 2012). Evidence on the effectiveness of these measures in LICs is still relatively scarce, compared to that available for developed and emerging economies. Given their country-specific characteristics, LICs need some clear guidelines on which regulatory and supervisory policies may work best in their economies, as the 2008-2009 global financial crisis raised doubts on the effectiveness of promoting the financial stability of the sophisticated prudential regulation and supervision used in the developed world which is currently applied to LICs.

It is clear that private capital flows, if well managed, may provide LICs with key funds to foster a sustainable growth path. However, policy-makers in LICs cannot rely entirely on experience in developed and emerging markets when selecting the most appropriate capital account management measures. LICs are characterised by certain specific economic, social and political features that should be imperatively taken into account when trying to develop effective capital account management tools. Therefore, additional effort should be made in gathering empirical evidence on LIC-specific experiences in capital account management, as well as in assessing the possible challenges that may arise in LICs when implementing certain policy measures. Past experience in emerging and developed economies, which has been carefully evaluated, might initially provide useful and relevant evidence.

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African experiences

6. Kenya financial sector: size, stability, efficiency and inclusiveness

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The Kenyan financial system is dominated by commercial banks, as is the case in many low-income countries. The country has a long history of commercial banking with the predecessors of the three major commercial banks set up before the 1920s. By independence in 1963, Kenya had 10 commercial banks with the 'big three' (Kenya Commercial Bank, Barclays Bank and Standard Bank) holding about 80% of the total deposits. The number of commercial banks continued to increase, reaching a peak of 67 in 1999 before declining to the current 43 as a result of mergers, acquisitions and closures. Of these 43 banks, 13 are foreign, accounting for 33.4% of commercial banks' total net assets; three are local public banks that account for 4.4% of total net assets; and 27 are local private banks that account for 62.8% of the total net assets (Kenya Bank Supervision Annual Report, 2012). Hence the banking system is dominated by local private and foreign banks.

A lot of work has been done on the relationship between the financial sector and economic performance, with many studies finding a close link between financial deepening, productivity and economic growth. It is estimated that policies that would raise the M2/GDP ratio by 10% would increase the long-term per capita growth rate by 0.2–0.4 percentage points (World Bank, 1994). In the simple AK model, the financial sector promotes the growth of the economy by raising the savings rate; the marginal productivity of capital and the proportion of savings that is channelled to investment. However, beyond a certain size, financial sector development becomes negative for economic growth, both through heightened financial instability, and the misallocation of financial resources (Spratt, 2013).

Kenya has a well-developed financial system for a country of its income level (Beck and Fuchs, 2004). Based on cross-country analysis, Kenya's level of financial development is not too far from its predicted level (Allen et al., 2012). Christensen (2010) classifies Kenya as a frontier market economy whose financial market is advanced, but does not yet have access to global financial markets to the same extent as emerging market economies in the region, such as MENA countries and South Africa. Its M3/GDP ratio is about 34% compared to an average of 63% for emerging market economies in 2008-2010. It is

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therefore unlikely that the size of Kenya's financial sector is beyond the threshold to negatively impact on economic growth. Griffith-Jones and Karwowski (2013) show that credit expansion in Kenya has been relatively modest in the last decade compared to other sub-Saharan African countries.

Kenya has numerous other financial institutions. These include the capital market, with the fifth-largest bourse by market capitalisation in Africa after South Africa, Egypt, Nigeria and Morocco; 37 insurance companies; 55 hire purchase companies (from three at independence); 10 development finance institutions (DFIs) that provide medium- and long-term finance; one mortgage company; 106 foreign exchange bureaux; a Post Office Savings Bank supported by 890 post offices throughout the country; 2,670 savings and cooperative credit societies in both rural and urban areas; about 1,100 registered private pension and provident providers; two credit reference bureaux launched in 2010; and eight deposit-taking microfinance institutions¹ (Central Bank of Kenya).

Despite the proliferation of financial institutions, almost one-third (32.9%) of Kenyans had no access to financial services and products in the 2009 Kenya Financial Access Survey. The period since the late 2000s has however seen a massive increase in access to financial services in Kenya. For example, deposit accounts have increased from about 2 million to 18 million, while loan accounts have increased from one million to three million since 2007². This has been driven by: (1) the introduction of mobile money financial services in 2007, (2) licensing of deposit-taking micro-financial institutions in 2009, and (3) the introduction of agency banking in 2010.

The adoption of mobile money services M-PESA in 2007 far exceeded expectations. Currently, there are four mobile money service providers, with a customer base of close to 20 million, about half the country's population, handling more than US\$19.9 billion worth of transactions per year, about 47% of the country's GDP. More research is needed to assess whether increased financial inclusion has compromised financial stability. The available evidence is conflicting. On one hand, the stock of e-money is postulated to be backed 100% by transaction accounts held at commercial banks, so that increased inclusiveness has not endangered financial stability. The e-float is also a small proportion of the other monetary aggregates in terms of size for it to matter much for monetary policy. Weil et al. (2011) for example estimate the outstanding stock of MPESA e-float at 1.6% of M0 and 0.4% of M1. On the other hand, there is increased instability in monetary relationships post-2007 undermining the current conduct of monetary policy, which assumes stable monetary relationships. Weil et al. (2011) show an accelerated decline in the income velocity of circulation; an unstable money demand function; and an increase in the money multiplier post-2007.

Significant efforts need to be made to reduce the cost of financial services in low-income countries (LICs) if financial access is to be expanded on a sustainable basis (Spratt, 2013). In Kenya, a wide range of measures have been implemented since the early 2000s to reduce the cost of doing business in the banking sector and enhance financial access. These include integration of mobile phone financial

¹ Central Bank of Kenya reports including Bank Supervision Annual Reports www.centralbank.go.ke

² Interview with the Governor, Central Bank of Kenya. *EastAfrican*, August 24-30, 2013.

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platforms, introduction of an agency banking model, and operationalisation of credit reference bureaux to reduce the cost of information searches and risks (Abdul et al., 2013). Evidence shows that the competitiveness and efficiency of the financial sector has substantially improved (Mwega, 2011).

Despite these developments, the interest rate spreads remained high. While the spreads in Kenya are comparable to those in the region, they are relatively high when compared to emerging economies like Malaysia (Abdul et al., 2013). The failure of market forces to bring down interest rates has resulted in various attempts by parliament to directly control them. The Central Bank of Kenya advocates for market solutions to address the structural constraints that lead to the high spreads such as: (1) improving the collateral process that handicaps the securitisation of loans and adds to cost of loans, (2) enhancing use of credit sharing information to deal with information asymmetry and reduce information search costs, and (3) revamping targeted interventions through loan programmes for small and medium enterprises (SMEs) and utilisation of development finance institutions with mandates for particular sectors.

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7. Nigerian banking sector reform: consolidation, structural change and SME financial exclusion

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The structure of the Nigerian banking sub-sector was fundamentally modified in 2004 when the Central Bank of Nigeria (CBN) began implementing financial reform that included a consolidation or re-capitalisation programme which raised commercial banks' capital base from N2 billion (\$12.5 million) to N25 billion (\$156.2 million). It was noted by the CBN that Nigerian banks were suffering from persistent illiquidity, weak capital base and corporate governance, poor quality of assets, insider abuse and over-dependence on public sector funds as savings (Soludo, 2004). Under a 13-point reform agenda for the Nigerian banking industry enunciated on 6 July 2004 by the then CBN Governor, Professor Chukwuma Soludo, the 89 banks were directed to raise their capital base to N25 billion on or before 31 December 2005. The CBN Governor stated inter alia:

"The Nigerian banking system today is fragile and marginal. Our vision is a banking system that is part of the global change, and which is strong, competitive and reliable. It is a banking system which depositors can trust, and investors can rely upon. Evolving such a banking system is a collective responsibility of all agents in the Nigerian economy."

At the end of the consolidation exercise in December 2005, only 25 banks emerged having met the re-capitalisation requirements. The emergence was through mergers, acquisition or stand-alone of about 75 banks, while 14 banks that failed to meet the requirements had their licences revoked.

Before the banking reforms, the banks could easily be classified into large, medium and small banks with each group serving different segments of society. Some of the banks were providing purely commercial banking services while others were in the merchant banking sphere and cooperative society banking. This implied that the functions were defined by their major activities. However, the banks were allowed by the CBN to go into universal banking with a view to accommodating all financial sector services, such as commercial, merchant and even development banking such that each bank could engage in short-, medium- and long-term financing.

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In addition to these banks, there were development banks, community banks and microfinance banks, some of which used the commercial banks as their correspondent banks. In the process of consolidation and the attendant mergers and acquisitions, as well as withdrawal of licenses, many of the community and microfinance banks lost their primary correspondent banks, and eventually their own licenses were suspended or withdrawn.

The outcome of the reform exercise was the emergence of 'mega banks' that had the inclination to serve only big corporate entities. Most small and medium-scale enterprises that were clients to hitherto small and medium-sized banks were ignored by the mega banks' operation in terms of provision of credits, as the banks were more concerned with becoming globally competitive. Noting the credit gap created and the death of development banks and many community banks, the CBN took action to promote the establishment of microfinance institutions, primary mortgage institutions and finance companies. At the end of December 2008, there were 24 universal or deposit money banks, five discount houses, 840 microfinance banks, 99 primary mortgage institutions and five development finance institutions (CBN, 2008).

Table 1 presents some financial indicators for the period 2004 to 2011. The table shows there have been some substantial increases in domestic credit to the economy, particularly to the private sector since the period of financial reforms in 2005 to 2009, but there have been concerns with shifts to government since 2010. There had been improvement in the financial depth as indicated by the M2/GDP ratio, but the huge gap between the saving and prime lending rate is indicative of an underdeveloped financial market. In practice, the actual market interest paid on loans with some administrative costs can be as high as 22-25%.

Table 1: Selected Financial Indicators (2004-2010)

Indicator (growth rate)	2004	2005	2006	2007	2008	2009	2010	2011
Net Domestic Credit	12.0	14.5	-69.1	276.4	84.2	59.2	10.0	42.4
Net Credit to Govt.	-17.9	-37.0	-732.8	-22.3	-31.2	25.9	51.3	52.7
Net Cr. to Private Sector	26.6	30.8	32.1	94.3	59.2	25.1	(3.8)	31.6
Cr. to Private/GDP (%)	13.1	13.6	14.2	23.7	32.1	39.2	30.2	24.0
M2/GDP (%)	19.4	19.1	21.5	27.7	37.2	42.7	39.5	36.4
Saving Rate (%)	4.4	3.3	3.3	3.2	3.6	3.6	1.5	1.41
Prime Lending Rate (%)	18.9	17.8	17.3	16.5	16.1	19.0	15.7	16.8
Inflation Rate (%)	15.0	17.9	8.2	5.4	11.6	12.5	13.7	10.8

Source: CBN Annual Report and Statement of Accounts, 2008 and 2011.

Table 2 shows that a large proportion of domestic credits by the Deposit Money Banks (DMBs) is on the short-term end of the credit market and directed at less-preferred sectors of the economy than priority

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sectors such as agriculture, manufacturing, solid minerals and exports. The financial reform was supposed to correct this anomaly, but was unable to do so.

Table 2: Maturity of DMBs Credits/Sectorial Shares (2007-2011)

Indicator	2007	2008	2009	2010	2011
Short-term (%)	75.8	75.4	70.3	65.3	60.0
Medium-term (1-3 years)	13.5	14.5	14.3	14.6	15.2
Long-term (3 years above)	10.7	10.7	15.3	20.1	24.8
Credit to:					
Priority Sector (%)	25.9	26.2	25.2	30.4	36.1
Less-Preferred Sector (%)	41.2	42.0	46.9	47.8	45.8
Unclassified (%)	32.9	31.8	27.9	21.8	18.1

Source: CBN Annual Report and Statement of Accounts, 2011.

It is important to note that lending by the DMBs, as indicated earlier, is to big-time borrowers, while small and medium enterprise borrowers must be satisfied with what is available in the microfinance banks (MFBs). Unfortunately, many of these MFBs have not been in good shape and in 2010 the CBN had to revoke the licences of 224 MFBs, but later granted 119 provisional licences (CBN, 2011). Even the special credit guarantee scheme established for the benefit of the small and medium enterprises (SMEs) has not been beneficial. For example, the CBN reported that the scheme offered no credit in 2010 and only 18 applications valued at N0.89 billion were guaranteed in 2011. The implications are that SMEs are at a serious disadvantage despite financial reforms and regulations over the years. A re-evaluation of regulations to promote real sector financing and financial inclusion of SMEs is imperative.

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8. Competition, efficiency and interest rate spread in Ghanaian banking

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High interest rate spreads and low credit availability to the private sector have been persistent problems in Ghanaian banking despite recent financial sector reforms. Ghanaian businesses have complained in recent years that high interest rates are squeezing the life out of private enterprises. The financial reform process in Ghana, which started in 1988 and continued through the 1990s, has resulted in changes in the structure of the banking sector and triggered the elimination of the regime characterised by official controls to a more market-based regime. Despite the positive results of these reforms, the interest rate spread remains excessively and persistently high. As a consequence, credit availability to the private sector remains limited.

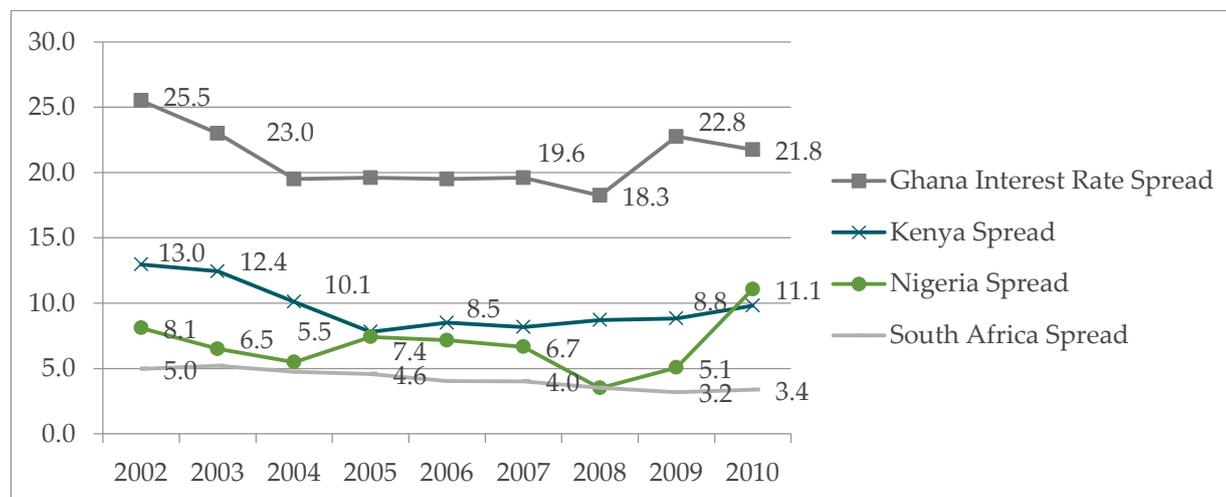
Interest rate spread can be defined as the difference between the rate of interest banks pay depositors and that which they charge borrowers. Several studies of bank spreads have examined the determinants of spreads in the banking systems of developing countries (see Demirguc-Kunt and Huizinga, 1999). They found several variables to be correlated with higher spreads, including: a lack of adequate competition in the banking industry; high inflation; high fixed and operating costs; perceived market risk; and the existence of regulatory constraints. In any case, **the persistence of wide interest rate spreads should be cause for concern for policy-makers because such spreads could be symptomatic of a number of systemic problems.**

Interest rate spreads have been observed to be relatively high in Ghana when compared to those in other countries in the sub region. Despite the recent financial sector reforms, which were aimed at enhancing competition, the spread, instead of narrowing, has been either stagnant or growing. Figure 1 reviews the trends in interest rate spreads for Ghana and three comparator African nations: Nigeria, South Africa and Kenya. The data indicates that in all the years under review, Ghana's interest rate spread far exceeded that of the three African countries; South Africa registered the lowest spread. It is reported that Ghana has the highest lending rates in Africa and one of the highest in the world.

Interest rate spread is often taken as a measure of banking efficiency or inefficiency. Wide spreads are generally thought to reflect inefficient financial service provision. When the spread is too high, it not only discourages potential savers with low returns but also discourages credit expansion because of high lending rates. Furthermore, it increases costs excessively for companies. The literature shows that wide spreads can be harmful to economic growth, as they are associated with credit rationing and thus contribute to financial disintermediation (see Williamson, 1987).

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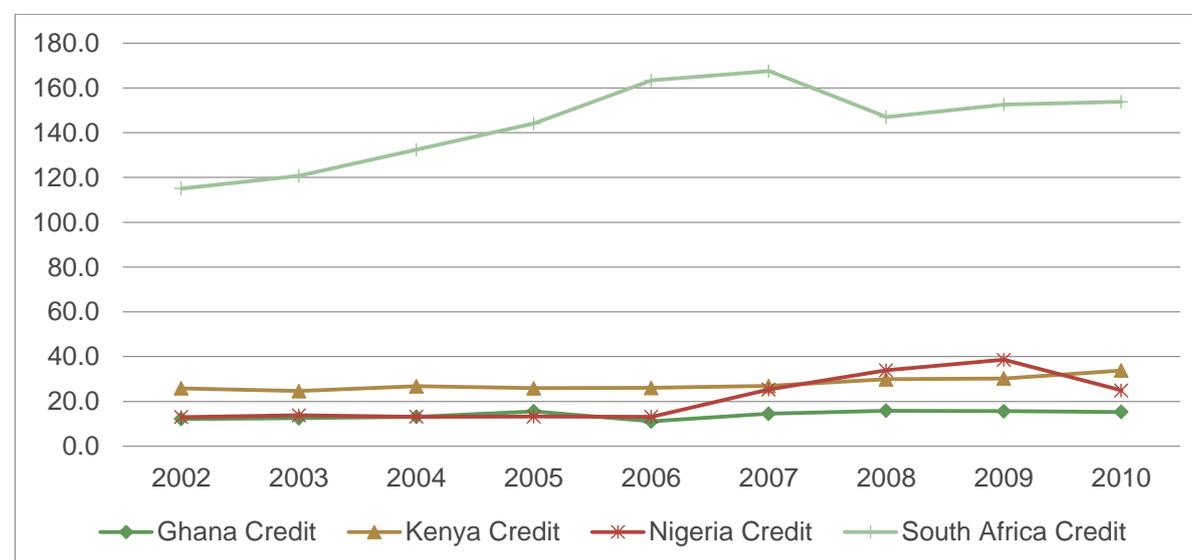
Figure 1: Trends in interest rate spread (%)



Source: World Bank: African Development Indicators 2013; Bank of Ghana

Figure 2 reports the trends in domestic credit to the private sector in Ghana, compared with the three comparator African countries. It is clear that credit to the private sector in Ghana has not grown. A hypothesis is that this has something to do with the relatively high interest rate spread in the country.

Figure 2: Trends in domestic credit to private sector (% GDP)



Source: World Bank: African Development Indicators 2013; Bank of Ghana

The literature on industrial organisation suggests that something is wrong with either the **structure** of the Ghanaian banking industry or the **conduct** of the banks operating in Ghana, or both. Ideally, as the market becomes more competitive with an increasing number of players in the industry, one expects the spread to be narrowing rather than widening. A competitive market is designed to be more efficient;

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firms are required to operate at the minimum cost of production, which will then lead to a manageable interest rate spread. However, this has not been the case for Ghana's banking sector over the past two decades. Despite growth in the number of banks in the industry, banks continue to charge interest rates far above the policy rate. The spread between the lending and deposit rates continues to be overly high. Moreover, Ghanaian banks are notoriously the most profitable in the sub region. This suggests there is a role for government or regulatory intervention to promote competition and prevent abuse of market power. There may be a good case for considering the introduction of competition (antitrust) and consumer protection laws to protect consumer welfare. A proper and careful analysis of Ghana's financial system is needed to identify the binding constraint on financial institutions to become more efficient, and thus to help broaden financial services to Ghanaian households and private enterprises.

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Lessons from Asia

9. Financial sector development for inclusive growth: lessons from India

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Comments made at the public panel debate on Financial Sector Development for Inclusive Growth at the University Of Ghana, Accra, 11 September 2013

Summary

- How do we encourage long-term financial savings to provide for long-term investment?
- Should these be through reformed development banks or through corporate bond markets or both - with or without some form of tax incentives?
- How do we ensure sound macroeconomic fundamentals and a strong resilient financial sector for obtaining benefits of liberalisation while minimising risks?
- Liberalising the domestic financial sector before the capital account has served India well. On the capital account, India has followed a calibrated and sequenced approach and favoured equity flows as opposed to debt flows.
- Good innovation should be encouraged, especially innovation that helps the real sector, as opposed to financial innovation for its own sake and for excess profit.
- How do we incentivise inclusive banking to make it a viable business without unduly high interest rates? How can subventions be used in a manner that does not have counter-productive outcomes?

The global financial crisis shook public confidence in the neoliberal financial system nurtured since the late 1970s. Are the answers that are being found today appropriate and sufficient to ensure a stable and sound financial system that supports global growth and welfare?

In India, for 40 years after independence until the 1990s, the political and economic philosophy was far from neoliberal. Democratic socialism, mixed economy and self-reliance were the underlying principles of public policy, with a strong commitment to equity, as well as the growth objective. For example, in agriculture, industry and services, while private ownership had its role to play, excess accumulation was prevented through a ceiling on land holding and restrictions on industrial capacity. Economic policy favoured small holdings of land and small scale industry and business, even if this meant not reaping the benefit of scale. Administered pricing was also quite common. The planning era, which commenced

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in the mid 1950s, gave the public sector a key role in basic manufacturing and trading, the so-called 'commanding heights'. Industrial and import policy was governed by licensing for setting up domestic industry and for imports which faced high tariff barriers. Foreign direct and foreign portfolio investments were restricted, and tight exchange controls prevailed. Monetary policy was subordinate to fiscal policy and there was automatic monetisation of the fiscal deficit. The balance of payments crisis of 1991 changed the country and policies irrevocably. Trade and investment was freed, tariff and non-tariff barriers were removed, domestic industrial licensing policy was abandoned, administered prices eliminated, taxation policies reformed, financial sector reform undertaken, government debt was issued through auction, and monetisation of government borrowing was stopped. In short, the private sector was allowed to exploit its potential and markets, by and large, were allowed to function.

India represents a country moving from a highly regulated, controlled and insulated economic system for 40 years, to a more open-market based system, with some elements of economic policy which, over the last 23 years, continue to give the State an important role.

The overall outcome has been extremely positive. The growth rate, which hovered at around 3% to 4% until the 1980s, rose steadily to 7% in the 1990s and 8% to 9% in the period until 2008, while moderating somewhat recently. This has implied opening up of opportunities for Indian enterprise and population. Growth has been sustained and stable with no significant downturns. Even in the years after the global financial crisis, growth rates have not reduced below 5%. Growth has taken place in a fairly benign inflationary environment especially in the period after the 1990s. There have not been any major upheavals in the financial system and the country has not confronted any serious banking or payments crises. The country withstood both the Asian and global crises fairly unscathed. Poverty has been significantly reduced, although not eliminated.

More recently, there has been a slowing down of growth, higher inflation and higher current account deficits. The hint of tapering led to a sell off in the Indian currency which saw a 20% drop to an all-time low of 68 Rs to one dollar, before recovering to 63 Rs on 10 September 2013.

What are the lessons from the Indian experience of liberalisation for low-income countries (LICs) in Africa?

1. The period prior to the 1990s showed us very clearly the potential costs of excessive control and regulation and the need to benefit from more competition, international trade and investment. The period also clearly demonstrated the perils of financial repression and state control over banking without sufficient prudential safeguards.
2. As an economy liberalises domestically and externally, it is open to higher risk and therefore needs to develop buffers in terms of sound macroeconomic fundamentals; low inflation, sustainable current and fiscal deficits and a strong, resilient banking system. Failure to ensure this can be extremely costly in terms of human welfare.

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3. India's approach to reforms was guided by five principles: cautious sequencing of reform measures; introduction of mutually reinforcing norms; initiating complementary reforms across sectors (monetary, fiscal, external and financial sectors); development of financial institutions; and growth and integration of financial markets. At the same time, regulations have been quite strong and markets are not unfettered.
4. Liberalisation of the domestic financial sector preceding capital account liberalisation has benefited the economy. The measures included freeing up administered interest rates, using price-based instruments rather than quantitative instruments for monetary policy, eliminating monetisation of fiscal deficits, reducing reserve requirements to prudential levels consistent with inflation management and following a flexible exchange rate policy. In the financial sector, allowing entry of new players while ensuring ownership and governance are 'fit and proper', restricting bank exposure to volatile asset markets while ensuring credit flows to productive sectors, and adopting international prudential norms while adapting them to suit local conditions have been essential aspects of the process of liberalisation.
5. In liberalising the external account, India has been extremely cautious. Equity flows - both foreign direct investment (FDI) and foreign institutional investment (FII) - have been encouraged and this has been very positive for the economy. Debt flows - especially short-term debt flows - are considered more volatile and have been subject to a variety of price-based and quantitative controls. Short-term debt is restricted only to trade credit. The banking sector is permitted very little access to overseas markets for funding local operations. Government borrowing from abroad is negligible and so far, sovereign bonds have not been issued. Overseas investment in domestic bonds, both corporate and government, are capped. The general principle followed is to be very careful in liberalising debt inflows as these can be huge, volatile and disruptive. The temptation to use overseas debt can be high in view of the interest rate differentials, but this can become quite costly if currency risk is taken into account. The risks of permitting large FII in government debt were recently apparent, when in the post-May period, huge FII debt outflows from India caused sharp and rapid currency depreciation.
6. A central bank and regulator must be sensitive to markets, but not capitulate to them. Quite apart from the need to 'take away the punch bowl when the party is at its best', the regulator must be able to show independence and courage in resisting pressure from markets, industry and media to deregulate further and further in the interest of market development. When required, regulators need to bring in prudential regulations.
7. There is a need to take the right lessons from crises. It is tempting to halt efforts to encourage innovation in the financial sector and bring in more controls. Countries like India need the right kind of innovation in the financial sector to be able to meet the risk reward profiles of savers and borrowers, and facilitate the right kind of finance for development of small businesses, new enterprises and infrastructure. For the financial sector to facilitate structural transformation, it is critical that it provides innovative products to increase financial savings of households, especially long-term savings. There is also a serious gap in long-term financing for infrastructure and capital expenditure. Whether this can come from specialised development institutions or from corporate bond markets is a choice that each country must make. If subsidies are required to

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enable this, policy-makers would do well to consider the best way this should be done - through tax incentives or outright grants to financial intermediaries. Similarly, incentives for financial inclusion may be required in initial stages before the investment begins to yield revenues.

10. Chinese development finance and the resource curse in Africa

Helmut Reisen¹ and Christina Wolf²

Not too long ago, on a visit to Zambia when she was still U.S. Secretary of State, Hillary Clinton voiced her concerns about a new colonialism - a colonialism in which emerging economic players such as China exploit African countries. Africa must beware of 'new colonialism' as China expands ties there, and focus instead on partners able to help build productive capacity on the continent. Clinton, asked in a television interview about China's rising influence on the continent, said that Africans should be wary of friends who only deal with elites. "We don't want to see a new colonialism in Africa," she said. "When people come to Africa to make investments, we want them to do well, but also want them to do good." "We don't want them to undermine good governance in Africa."³

While indicative of the rivalry between today's two superpowers when dealing with developing countries, Mrs Clinton's statements summarised well some of the important concerns often advanced against the 'new' donor China.

The need for raw materials to fuel their growing economies has driven emerging economies such as China to intensify their engagement in sub-Saharan Africa. For those African countries, however, the proceeds of their resource riches have rarely been the start of a sustainable development path. More often than not, the resource revenues have failed to be invested for the benefit of the broader population and the poor. Rather than financing economic development, they have at times fuelled off-shore bank accounts of corrupt elites. Worse, resource earnings have triggered armed conflict in the struggle for resource rents under weak rule of law, especially in countries where ethnic divisions and the geographic concentration of non-renewables are colliding⁴.

Until recently, a collection of blame⁵ against China's and other new partners' cooperation programmes invariably warned that they amounted to:

- violation of corporate and national governance standards
- free riding on debt relief

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³ "[Zambia, China and theworldofhillaryclinton.com](http://Zambia.China.and.theworldofhillaryclinton.com)", *shiftingwealth.blogspot.com*, 19 June 2011.

⁴ De Soysa, I. and Neumeier, E. (2007) 'Resource Wealth and the Risk of Civil War Onset: Results from a New Dataset of Natural Resource Rents, 1970-1999', *Conflict Management and Peace Science* Vol. 24(7).

⁵ See, e.g. Manning, R. (2006) 'Will 'Emerging Donors' Change the Face of International Cooperation?' *Development Policy Review* Vol. 24(4).

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- unfair company competition
- scramble for extraction rights and resource curse.

Moreover, the growing relevance of 'Eastern donors' has been seen as weakening the efficiency of Western soft-law standards in the field of development co-operation and has raised the question of how compliance with these standards can be assured in a changing donor landscape⁶. Summarised in short and mean terms, Chinese cooperation was labelled as 'rogue aid'⁷.

Indeed, the Chinese Government is not participating in Western transparency initiatives such as the Extractive Industries Transparency Initiative (EITI), which requires participants to reveal payments from extractive industries to governments. China is also not inclined to tie its loans to African countries to any standard of 'good governance'.

However, it is not clear just how bad a thing this is.

- The U.S. Government Accountability Office (GAO) recently published a careful case study⁸ which concluded that the grant element in reported government loans was higher (not lower) for the Chinese than for U.S. loans (and both were lower than for World Bank loans).
- A comparison of World Bank governance indicators (corruption control; rule of law; government effectiveness; and regulatory quality) and of IFC Cost of Doing Business Indicators (days to export; days to import) showed for the 2000s that China-centric Africa (Chinese foreign direct investment (FDI) dominance, as measured by the Heritage Foundation investment tracker) scored better than residual African countries⁹.

On the other hand, participation in the EITI does not seem to reduce corruption¹⁰. Perhaps the middle classes in sub-Saharan Africa are unable to use the information provided through these transparency initiatives to hold governments to account. In short, it may not matter much whether Africa's emerging partners participate in these failed Western-inspired anti-corruption drives.

China's mode of cooperation with African countries may be superior to the Western approach in some regards. In fact, rather than just extracting resources, as is often insinuated, China engages in a more complex exchange with its African partners.

A typical deal might look like this: a Chinese contractor – often with a credit from the China Exim Bank and always with agreement from the African country – delivers an infrastructure project. The African country pays for this work through direct raw material exports and shares in its national resource, extracting industries or concessions.

⁶ Paulo, S. and Reisen, H. (2010) 'Eastern Donors and Western Soft Law', *Development Policy Review* Vol. 28(5).

⁷ Naim, M. (2009) 'Rogue Aid', *Foreign Policy*, March.

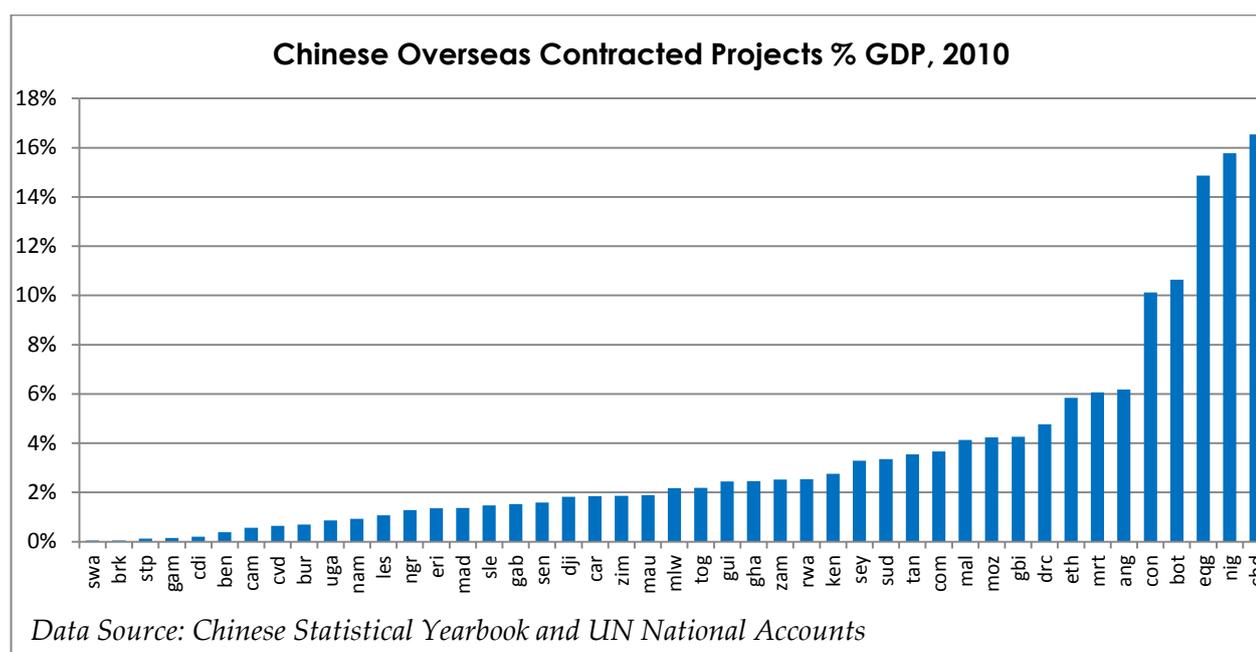
⁸ GAO (2013), '[Sub-Saharan Africa: Case Studies of U.S. and Chinese Engagement in Angola, Ghana and Kenya](#)', GAO-13-280SP, February.

⁹ '[Indicators of Hard and Soft Infrastructure in China-Heavy Africa](#)', [shiftingwealth.blogspot.com](#), 12 August 2011.

¹⁰ Ölcer, D. (2009) *Extracting the Maximum from the EITI*, OECD Development Centre Working Paper No.276.

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Given their large scale, these infrastructure projects constitute for some countries a significant source of employment. Survey data from 32 Chinese companies in the Angolan construction sector reveal that 51% of the labour content is sourced locally. What is more, both large and small Chinese firms have a tendency to employ more labour the longer they stay in the market. Overall, the number of local semi-skilled workers (brick layers, masons) on Chinese construction sites increases¹¹. These employment effects can have a substantial macroeconomic impact, given that the face value of Chinese contracted projects is more than 5% of GDP in some African countries¹².



In terms of governance outcomes, it is significant to note that Chinese credits are often tied in with specific infrastructure investments and Chinese contractors are involved locally, making it easier to ensure projects go ahead. The smaller cash component of the loans reduces rent-seeking behaviour and projects often bypass the authority of lower level administrations in the African country. As a result, it is much more difficult to divert funds into plutocrat's purses, and the money is more likely to be used for the public good. Indeed, according to the Ibrahim Index, two major recipients of China's 'rogue aid', Angola and DRC, are among the five African countries with the biggest improvements in the quality of public services.

The Chinese mode of engagement forces raw material-rich countries to invest at least some of their revenues into projects that are beneficial to the country as a whole. Even though it avoids the grand posturing and rhetoric of 'good governance', China may thus contribute to turning raw material richness into a boon rather than a curse for people in sub-Saharan Africa.

¹¹ Corkin, L. (2011) *Chinese Construction Companies in Angola: A Local Linkages Perspective*. MMCP Discussion Paper No. 2. University of Cape Town and Open University.

¹² Chinese Statistical Yearbook, various years. Chinese Statistical yearbook measures as 'Chinese Overseas Contracted Projects' all projects financed by Chinese aid, institutional and foreign investors, carried out by Chinese firms in third countries.

11. Development finance for structural transformation and inclusive growth: Asian experiences

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Overview

In this note, 'development finance' is understood broadly as financing from domestic and external sources, both public and private, for investment serving development purposes in developing countries, drawing on the definition of a recent study on changes in development finance in Asia (Nishizawa, 2011). Among development purposes, the author focuses on industrialisation and inclusive growth.

In the public panel held on 11 September in Accra, Ghana on 'challenges of developing a stable and efficient financial system that supports inclusive growth', a widely shared view among panellists was: "Finance is again seen as a means to an end, rather than an end in itself. Its job is to facilitate growth and rising living standards through the real economy, and the job of regulation is to ensure that this is achieved. There are two aspects to this. First, regulation needs to minimise instability emanating from the financial system that negatively affects the real economy. In particular, it needs to prevent, mitigate and – if necessary – resolve financial crises. Second, regulation should facilitate productive economic activity, through the efficient allocation of credit, and the provision of effective investment and insurance products" (Spratt, 2013).

From this perspective, East Asian experiences seem highly relevant, because financial institutions played an important role in industrialisation and inclusive growth in the region. The East Asian governments created financial institutions to provide long-term loans with low interest rates, helping their countries promote economic development through industrialisation and infrastructure building. They encouraged inclusive development by providing credit to agriculture and small and medium firms. The World Bank's East Asian Miracle, one of the most prominent studies on the region's dynamic growth, highlighted the following three aspects: East Asian governments created a wide range of financial institutions to fill perceived gaps in the types of credit provided by private entities; they addressed the need for long-term credit for industry by creating development banks; and most have also created specialised institutions that provide credit to agriculture and small firms (World Bank, 1993).

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Industrial development banks have been substantial long-term lenders in Indonesia, Japan, Korea and Taiwan, China, but not in the other High Performing Asian Economies (HPAEs)¹. In ASEAN (Association of South East Asian Nations) countries where industrialisation coincided with the expansion of foreign direct investment and financial globalisation, public financial institutions in general stimulated inclusive growth, supporting mainly small and medium industries and agriculture.

Dependency on foreign capital is generally low for Japan, South Korea and Taiwan as the share of foreign direct investment (FDI) against gross capital formation in these countries amounts to not more than 5% for most of the period. In ASEAN countries, FDI dependency is extremely high, as the ratio hovered around 10% to 15% for Indonesia, the Philippines and Thailand after the 1980s (except for the Asian currency crisis period), not to mention the case of Singapore which is highly dependent on foreign capital.

Comparison between Far East Asian countries and ASEAN countries

Development strategies were different between these two groups of countries: industrialisation in Far East Asian countries was facilitated by preferential interest rates, in which the government accomplished the role of coordinator between the financial sector and real (industrial) sector due to the fact that industrialisation started when global financial flows were very limited, while in ASEAN countries, foreign enterprises played the major role of establishing new industries under the policies of financial liberalisation and trade liberalisation, due to the fact that these countries' industrialisation started when FDI and global financial flows increased.

Development financing must address inherent challenges. Coping with the risks of industrial development, overcoming difficulties in evaluation and monitoring of investment, and providing long-term credit are among the most important. Teranishi et al. (2008) analysed the differences between the Far East Asian model and the ASEAN model in terms of these issues. Regarding the first point, governments in Far East Asia shared a part of the risks of investment in new industries to reduce the risks for private financial institutions as risks of investment in new industries were too large for private financial institutions to take alone. In ASEAN countries, risks of investment in new industries were smaller, as foreign enterprises had rich experience. Regarding the second point, government or public financial institutions in Far East Asia evaluated profitability and risks of new industries on behalf of private financial institutions. In ASEAN countries, evaluation on investment was not necessary as foreign enterprises with rich experiences made investments. With regard to the third point, while long-term financial resources were introduced by policy-based finance of government or government financial institutions in Far East Asia, foreign enterprises were able to obtain long-term finance from overseas in ASEAN countries.

¹ In Japan, the development banks, the public Japan Development Bank (JDB) and the private Industrial Bank of Japan (IBJ) accounted for about two-thirds of loans outstanding for equipment investment in the 1950s and about half in the early 1960s. The Korean Development Bank made an average of one-third of all loans and guarantees in the 1970s, and the development bank of Taiwan, China, the Bank of Communications, holds about half of the assets of the banking system (World Bank 1993).

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Lessons learned

Industrialisation and economic transformation were essential for inclusive development, especially for generating 'good' jobs, critical for improvement of living standards, of productivity and social cohesion (World Bank, 2012).

In Far East Asian countries, policy-based financial institutions not only provided low-interest loans for economic transformation and inclusive development, but were instrumental in preventing disorder in the finance sector, which can be common in developing countries due to poor monetary policy. Far East Asian governments supported a number of policies to avoid such problems.

JICA/JBIC (2008) highlights that, in Far East Asia, governments committed resources to investment projects as a measure against private financial institutions' weak risk diversification. The market took this as a tacit signal of a guarantee of a project's success. This demonstration of government commitment made it easier to invest in new industries. Moreover, policy-based financial institutions provided the screening services which private financial institutions often lacked. In other words, government commitment was understood as justification for investment, and so private financial institutions left screening to their government to avoid problems. In the end, while the underdeveloped financial sector could not provide adequate long-term funding, government-affiliated financial institutions supplemented the shortage.

In ASEAN countries, large industries were financed by FDI and related external finance, while small and medium enterprises (SMEs) and agriculture were, generally, financed by public financial institutions and local commercial banks. These sectors have been crucial to inclusive development in the region.

In Indonesia, earnings from oil and mineral resources made vital contributions to agriculture and rural development, providing a basis for long-term economic growth. Effectively combining supply-side support measures (high quality seeds, chemical fertilisers, irrigation infrastructure and agricultural finance) and demand-side support measures (producer price support in the improvement of agricultural productivity, etc.) proved crucial to success (JICA/JBIC, 2008). In Thailand and Malaysia, small and medium enterprises were supported to be developed as supporting industries for establishing a competitive automobile industry (JBIC, 2001).

As discussed above, size, structure and the role of development finance differ according to the development objectives of the country, the domestic financial system and its evolution, and the globalisation process of finance and increases in FDI. For further development of the financial system in sub-Saharan Africa, enhancing their support for inclusive development, African countries could learn lessons from the experience of East Asia, despite the different backgrounds.

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Future Research Directions

12. Finance for development: a context-specific policy agenda

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For better or worse, the financial sector plays a critical role in modern market economies. While it can be a force for development, by providing basic payment and transaction services, intermediating society's savings to its best uses, offering households, enterprises and governments risk management tools, it can also be a source of fragility, as we were reminded during the global financial crisis and the ongoing Eurozone crisis, but also by numerous banking crises in emerging and developing markets.

This short note summarises empirical research on the relationship between finance and the real economy and provides a framework for designing appropriate policy for sustainable development of the financial sector.

Finance is pro-growth...

Theoretical literature has shown that financial deepening can have a positive effect on economic development (though the effect is not unambiguous) and has identified several channels through which this effect can happen. Specifically, efficient financial systems might enhance economic development by: (i) providing payment services, reducing transaction costs and thus enabling the efficient exchange of goods and services as well as specialisation of labour, (ii) pooling savings from many individual savers, thus helping overcome investment indivisibilities and allowing to exploit scale economies¹, (iii) economising on screening and monitoring costs and thus increasing overall investment and improving resource allocation, (iv) helping monitor enterprises and reduce agency problems within firms between management and majority and minority shareholders, again improving resource allocation, and (v) helping reduce liquidity risk, thus enabling long-term investment, as shown by Diamond and Dybvig (1983).

¹ See, for example, McKinnon (1973) and Acemoglu and Zilibotti (1997).

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Extensive empirical literature has shown a pro-growth effect of financial deepening. What started with simple cross-country regressions, as used by King and Levine (1993), has developed into a large literature using an array of different techniques to look beyond correlation and control for biases arising from endogeneity and omitted variables. Specifically, using instrumental variable approaches; difference-in-difference approaches that consider the differential impact of finance on specific sectors and thus point to a smoking gun; explorations of specific regulatory changes that led to financial deepening in individual countries; and micro-level approaches using firm-level data have all provided the same result: financial deepening is a critical part of the overall development process of a country (see Levine, 2005, for an overview and Beck, 2009, for detailed discussions of the different techniques). While many of these studies are for a broad cross-section of countries, others are for specific regions or income groups². The cross-country regression analysis has been confirmed with historic case studies and long-term statistical studies of individual countries.

... but with important non-linear effects

More recent empirical evidence has shown that the relationship between finance and growth varies across countries at different levels of economic development. Rioja and Valev (2004) show that the effect of finance on growth is strongest for middle-income countries. These findings are consistent with Rousseau and D'Onofrio (2013) who show that it is monetisation rather than financial intermediation that seems to matter for growth across sub-Saharan Africa. Aghion, Howitt and Mayer-Foulkes (2005) argue that the impact of finance on growth is strongest among low- and middle-income countries that are catching up to high-income countries in their productivity levels, and fades away as countries approach the global productivity frontier. More recent evidence has shown a possible negative impact of finance on growth at very high levels of financial development (Arcand, Berkes and Panizza, 2012). Several reasons have been put forward to explain this non-linear or even negative impact of finance on growth, including extension of the financial sector beyond traditional intermediation activities, the extension of credit to households rather than enterprises, and an over-extension of the financial system at the expense of the real sector due to informational rents of the financial safety net subsidy (see Beck, 2012, for a more extensive discussion). Most of these phenomena apply more to high-income than developing or emerging economies, but have important lessons for today's developing countries.

Finance is also pro-poor...

Recent evidence has shown that financial deepening is not only pro-growth, but also pro-poor. While theory makes ambiguous predictions about the relationship between financial deepening and income inequality, most of the recent empirical literature has shown a negative long-term relationship. Beck, Demirgüç-Kunt and Levine (2007) show that countries with higher levels of financial development experience faster reductions in income inequality and poverty levels. Clarke, Xu and Zou (2006) show a negative relationship between financial sector development and the level of poverty. On the country-level, Beck, Levine and Levkov (2010) show that branch deregulation across U.S. states in the 1970s and 1980s helped reduce income inequality; Gine and Townsend (2004) show that financial liberalisation can

² See for example, a recent study on the finance and growth relationship within sub-Saharan Africa, Rousseau and D'Onofrio (2013).

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explain the reduction in poverty in Thailand over the period 1975 to 2000, and Ayyagari, Beck and Hoseini (2013) show that financial deepening following the 1991 liberalisation episode can explain reductions in rural poverty across India.

...but also very fragile

While finance can be an important factor in economic development, it can also wreak havoc on economies. The same mechanism that makes finance growth-enhancing also contains the seed of destruction, as illustrated by the Diamond and Dybvig (1983) model. By transforming short-term liabilities into long-term assets, banks can foster economic growth but can also become susceptible to bank runs, be they informed or uninformed. Agency problems between banks and their depositors and creditors can lead to excessive risk taking and fragility. Herding trends and self-reinforcing price cycles fuel boom-and-bust cycles.

Financial history is full of bank failures and financial boom-and-bust cycles, linked to a variety of factors, often with similar features (Reinhart and Rogoff, 2009). To the same extent that well-developed financial systems can foster economic growth, banking crises are often associated with deep economic recessions and long-term negative growth repercussions³. Crises hit the poor more than average citizens, through job and income losses and cuts in social government programmes⁴. Comparisons of economic crises have shown that economic recessions related to banking distress tend to be deeper and longer than other recessions⁵. Specifically, output losses of recessions with credit crunches are two or three times as high as in other recessions.

The Goldilocks level of financial development

As discussed above, the financial system can be too cold and too hot. Which policies and interventions lead to a financial system that is 'just right'? The concept of the financial possibility frontier can serve as a framework to identify bottlenecks in a country's process of financial deepening and different policy areas to overcome them. It can also serve as a basis to discuss the role of different segments of the financial system (banks, capital markets, contractual savings institutions, low-end financial institutions), their development and importance as countries' financial systems develop, and their impact on growth.

The efficiency with which financial institutions and markets can overcome market frictions is critically influenced by a number of state variables—factors that are invariant in the short term (often lying outside the purview of policy-makers)—that affect provision of financial services on the supply side and can constrain participation on the demand side. State variables, thus, impose an upper limit of financial deepening in an economy at a given point in time. These variables are either directly related to the financial sector (for example, macroeconomic fundamentals, the available technology, contractual and information frameworks underpinning the financial system, prudential oversight) or related to the

³ The costs of systemic banking distress can be substantial, as reported by Laeven and Valencia (2008), reaching over 50% of GDP in some cases in fiscal costs and over 100% in output loss.

⁴ See Brown (2013) and literature cited therein.

⁵ See Claessens, Kose and Terrones (2008).

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broader socio-political and structural environment in which the financial system operates. Among the state variables is also the size of the market, and problems in many developing countries are related to the oft-found triple problem of smallness—small transactions, small financial institutions and small market size—which reduces the possibilities to diversify and hedge risks, while at the same time increasing concentration risks.

Using the concept of state variables allows us to define the financial possibility frontier as a rationed equilibrium of realised supply and demand, variously affected by market frictions. In other words, this is the maximum sustainable depth (e.g., credit or deposit volumes), outreach (e.g., share of population reached) or breadth of a financial system (e.g., diversity of domestic sources of long-term finance) that can realistically be achieved at a given point in time and maintained without risk of fragility⁶.

The financial possibility frontier also allows us to distinguish between several challenges to deepen and broaden financial systems in developing countries and the corresponding policies. There are situations, where: (i) a financial system is below the frontier, (ii) is above the frontier, and (iii) the frontier is too low. These challenges can be mapped into policy areas. Market-developing policies aim at long-term institution building that help push out the frontier and include legal (even constitutional) changes and substantial upgrading of macroeconomic (particularly fiscal) performance. More short-term market-enabling policies aim to push the financial system towards the frontier, by fostering competition, the adoption of new technologies and alleviating demand-side constraints through regulatory and tax policies or specific interventions, such as financial literacy programmes or credit guarantee schemes. Market-harnessing policies aim to prevent the financial system moving beyond the frontier towards an unsustainable position and include the regulatory and supervisory framework, macroeconomic and macro-prudential management, but can also comprise demand-side policies such as consumer protection laws and programmes to prevent over-indebtedness.

All financial sector policy is local

Most importantly, the appropriate mix of market-developing, enabling and harnessing policies varies across countries with different levels and structures of the financial system. Bottlenecks and constraints vary across countries. However, political economy constraints might also vary across countries and enable or constrain the adoption of the necessary policies. One size does not fit all and all financial sector policy is local.

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13. Policy-relevant research for the financial sector in low-income countries

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Finance provides a particularly challenging and important field for policy-relevant research on financial stability, as well as inclusive growth for African low-income countries (LICs). The research needs are very large, for two reasons. First, African LICs face the traditional challenge of expanding access to large parts of the population and important segments of enterprises excluded from the financial sector; furthermore, where access is available, it is often too short term and very costly. These features are an important obstacle for growth. Overall, financial sectors in LICs are still relatively shallow. Based on World Bank data, the average credit-to-GDP ratio in 2010 for sub-Saharan African LICs was below 20%, though higher in some countries (see Griffith-Jones with Karwowski, 2013). According to World Bank surveys, only 17% of small enterprises in sub-Saharan Africa have access to credit, the lowest among all developing country regions, with, for example, 41% of small enterprises in Latin America and the Caribbean reporting access to credit. Some 48% of small enterprises in sub-Saharan Africa report that access to credit is a major constraint for their investment, with 41% of even medium enterprises in sub-Saharan Africa saying that lack of credit hinders their investment.

Second, internationally, there is a rethinking of the role, scale and structure of a desirable financial sector, as well as its regulation, in light of the major financial crisis that started in 2007/2008. There is a need to understand the implications (or not) of this analytical rethinking for low-income countries' financial sectors, especially regarding its impact. As Wampah (2013) eloquently states in this volume, the financial sector is a 'double-edged sword', with potentially very large positive effects for inclusive growth, but also, if not robustly regulated, "because the absence of this (regulation) could have disastrous outcomes, as observed during the recent global financial and economic crises".

Because financial sectors for African LICs are still at an early stage of development, lessons from the crisis could inform their financial sector development strategies. The advantage of being a latecomer to financial development is that African LICs can learn both positive and negative lessons from financial development and crises in other regions.

LICs' financial sectors, while generally still shallow, are in some countries experiencing fairly rapid growth. This growth is often concentrated in credit to real estate or households more generally (see for example, Griffith-Jones with Karwowski, 2013). Combined with African countries' vulnerabilities, such as to external shocks, this might pose risks to financial system stability in the future. While it is positive that in the last ten years in sub-Saharan Africa there has been only one major banking crisis (in Nigeria),

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care must be taken that such a positive record does not generate complacency that financial stability is ensured, as occurred so frequently in most other regions of the world.

One positive advantage of regulation in several African countries may be that they have developed a different approach, which seems better suited to African realities than internationally adopted regulation rules that are extremely complex¹.

The DFID-ESRC Growth Research Programme project on 'Financial regulation in low-income countries: balancing inclusive growth with financial stability', is, in this context, focusing on the following broad issues:

- identifying key national risks to financial stability as well as gaps in the financial sector for funding inclusive growth;
- regulatory measures to support financial stability;
- where relevant, management of capital account, for the same purpose;
- advantages and problems of different mechanisms for such regulation, given country characteristics (weak institutions, information problems).

More specifically, the key research and policy questions for country studies are:

- Main opportunities (such as in some cases new natural resources) and challenges (like lack of access and high cost of credit, especially for SMEs).
- What sort of financial system is needed to seize growth opportunities, as well as manage challenges to financial stability?
- What scale of financial sector, and what pace of growth is desirable? Is the key challenge in particular countries one of expanding access for certain sectors and social groups, or are main challenges to maintain financial stability? For the latter, indicators such as non-performing loans are helpful, as well as too rapid pace of credit growth.
- With regard to access to credit, there are two issues: Is there enough access to credit, especially for SMEs; is it of enough maturity? The second issue is the excessive cost of credit. Here, careful empirical analysis of the cost of intermediation and its evolution is important. What causes the evolution of cost of lending? If it has remained high, even in the face of changes within the banking industry that should have increased competition, such as increase in number of banks, why has the cost not come down, or so little? Last, but perhaps most importantly, what are policy solutions to deal with this issue?
- With regard to the structure of the banking sector, what is the role of foreign and public development banks? How well have these particular categories performed, in terms of financial indicators, but also in terms of economic indicators, such as providing access to credit to SMEs, as well as the rest of the private sector? Is there a need for a greater role for *good* public development banks, to cover gaps in financing in key sectors, essential for inclusive growth? How can these be expanded/created? Issues of incentives and governance are essential here.

¹ See Bagyenda, J., Brownbridge, M. and Kasekende, L. (2011) for analysis of such an approach, which includes limiting the amount banks can lend to individual borrowers and encourages banks to have a structure of assets that are less risky.

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- More broadly, on domestic financial regulation, how important is implementing Basel II/III for ensuring financial stability? What aspects are essential? Liquidity/capital requirements/others? Are levels of capital adequacy in LICs' banks sufficient to ensure financial stability? If increased, could this increase the cost of credit?
- Is the regulatory toolkit in LICs more reliant on other variables such as structure of banking assets, which may be more relevant for LICs? What are capacity constraints for implementing different regulation and *supervision*, such as lack of information, insufficient staff, and how could they be overcome? Should counter-cyclical regulation be introduced? How should it be done? At the aggregate level of total credit expansion, or focussed on specific sectors?
- What institutions/mechanisms are available in the banking system for financial inclusion? How successful are they in providing access to the poorer segments of society? Do they pose sustainability risks for the individual users and/or financial stability risks in the macro sense?
- What is the structure and level of capital flows? Has there been a recent expansion of foreign capital flows, e.g. via bonds? What can be done to encourage long-term capital flows that enhance development potential? What are desirable levels of sustainable foreign debt in LICs? How can the capital account best be regulated to avoid future currency or banking crises? Should it be done through regulating currency mismatches in lending to banks and companies? Or should market-friendly counter-cyclical capital controls on inflows of short-term capital also play a role?

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