

Chapter 1

Financing Africa: Setting the Stage

Introduction

Cautious hope is in the air for finance in Africa. While the global crisis may have dented some of the progress made since the beginning of the 21st century, one feels the optimism and sees the positive trends. A deepening of financial systems can be observed in many African countries, with more financial services, especially credit, provided to more enterprises and households. New players and new products, often enabled by new technologies, have helped broaden access to financial services, especially savings and payment products. Innovative approaches to reaching out to previously unbanked parts of the population go beyond cell phone-based M-Pesa in Kenya and basic transaction accounts, such as Mzansi accounts in South Africa. Competition and innovation dominate African financial systems, and, for every failure, there is now at least one success. However, many challenges remain, and the journey toward deeper, more-efficient, and more-inclusive financial systems will be long and fraught with many difficult choices in many countries in Africa.

Africa's financial systems have progressed over the past 20 years. Yes, the promise of the efforts at liberalization, privatization, and stabilization in the 1980s has only been partly fulfilled, though African finance has been stable for quite a while now. Since the peak of the banking crises in the 1980s, there have been few systemic banking crises, though pockets of fragility persist, often related to political crisis or deficiencies in governance. On average, banks in Africa are well capitalized and liquid. Still, the benefits of deeper, broader, and cheaper finance have not yet been reaped. Finance in Africa still faces problems of scale and volatility. And the same liquidity that helps reduce volatility and fragility in the financial system is also a sign of the limited intermediation capacity on the continent. Nonetheless, as we discuss below, globalization, technology, and increasing regional integration may provide new opportunities for finance in Africa.

As a consequence of recent positive trends, African financial sectors entered the crisis with a cushion of high levels of capitalization and liquidity. Financial institutions on the continent largely evaded the direct impact of the global financial crisis. Low levels of integration with international financial markets limited the exposure to toxic assets and to the volatility of international markets. With a number of important exceptions, nonperforming loans remained stable despite the slowdown in economic growth. Notwithstanding the limited impact of the global financial crisis and the improvements in overall stability, several countries have been suffering from homegrown financial fragility related to governance challenges and socio-political unrest.

Africa's economies have been hit by the ensuing Great Recession through reduced trade flows and reduced portfolio flows and remittances. The fall in demand and, consequently, in the prices of commodities has hit commodity-based economies significantly. The rapid decline in global trade that started in late 2008 (by up to 45 percent in real terms year on year) affected all African economies and, to a large extent, explains the lower growth the region experienced in 2009. The increasing spreads and reduced maturities resulting from the shortage of liquidity in the global financial system have made investment and trade more difficult as well. Africa has also experienced a rapid reduction in capital flows, which has depressed stock exchange indexes throughout the continent and forced governments and companies to cancel bond and stock issues. Nonetheless, the overall impact of the Global Recession seems to have been milder on Africa than on other regions of the world, and the continent is already expected to match precrisis growth rates of 5 percent in 2011 (IMF 2011).

More importantly, Africa will be affected by long-term trends that started before the crisis and have been reinforced by the crisis, especially the shifts in the distribution of global economic power. The shift of weight away from the North (the G-7) toward the East (especially China and India) and the South (to the G-20) has been another consequence of the crisis not only for Africa, but also for the global financial and economic system. In the context of globalization, the BRIC countries, especially China and India, but, more recently, also Brazil, are playing a growing role in Africa.¹ This is reflected in capital flows and also the structure of banking systems. While Indian banks have long had a presence in East African countries, the purchase of a 20 percent stake by a Chinese bank in Standard Bank in South Africa represents a new trend for China. The foreign direct investment of Brazil, China, and India has been increasing across the continent. It began mostly in natural resource extraction and agriculture, but has now extended to other sectors. Additional funds have been forthcoming from the Gulf region, often in the form of sovereign funds. This shift in capital flows and international governance offers opportunities and challenges for Africa: opportunities in terms of urgently needed resources and challenges in terms of managing the resources properly.

This chapter opens with a description of the book's objectives and contributions, including the main policy messages. It then develops the basic analytical

framework through which we view financial sector development in Africa, distinguishing among beneficiary concepts and groups so as to focus our policy messages. We highlight the importance of financial sector development for economic growth and poverty alleviation and conclude with a summary of the persistent problems in Africa—limited scale, informality, volatility, and governance issues—that require new solutions. Opportunities for solutions are possible within the new trends of globalization, regional integration, and technology.

Financing Africa, the Book

This book targets the stakeholders in Africa's financial systems. Stakeholders are understood widely: policy makers, regulators, practitioners, development partners, academics, and others. The book includes a stocktaking and forward-looking exercise that indicates viable paths to financial sector deepening and broadening. It represents an effort to document new and existing trends in Africa's financial sectors, taking into account Africa's many different experiences. It focuses on general trends and, thus, does not encompass an exhaustive, detailed discussion of the development and structure of each of the 53 African financial systems (for example, see Allen, Otchere, and Senbet 2010).

The book intends to contribute to the efforts of African policy makers to capture opportunities and overcome challenges. It outlines broad policy messages for financial systems in Africa on the premise that one size does not fit all. It does not outline strategies for the financial sector in every country across the continent, but, rather, offers general policy messages. It also discusses specific segments of the financial sector, such as rural and housing finance; it does not, however, offer an exhaustive and conclusive coverage of these segments. We leave that to more specialized publications in these areas.

The book builds on and extends substantially the World Bank publication *Making Finance Work for Africa*, which drew attention to the opportunities and challenges of financial system development across Africa (see Honohan and Beck 2007). First, it relies on a much broader array of data than the previous publication. Second, it includes North African countries in the analysis, which, along many dimensions, have followed a different path of financial sector development. Finally, it expands on the analysis of the previous publication, including a thorough discussion of the regulatory challenges of finance in Africa. Critically, the world is different in 2011 from the world in 2007. Box 1.1 summarizes the main differences between the two publications.

An Analytical Framework

In theory, financial institutions and markets exist to help overcome market frictions that make direct exchanges between economic agents difficult. Academics typically distinguish between specific functions of financial service providers, such

Box 1.1 What's New?

Financing Africa is a follow-up to *Making Finance Work for Africa*. What has changed since early 2007, and what distinguishes this publication from the previous one?

The environment has changed

The environment in which African financial systems operate has changed dramatically over the past four years. The number of African countries experiencing a systemic banking crisis has fallen from a peak of 15 in the mid-1990s to a sporadic outlier in the 2000s. Credit to the private sector (as a ratio of gross domestic product [GDP]) has risen by more than 20 percentage points since 1990. There has been a growing trend toward regional integration within the continent in recent years, though this trend started well before 2007. Kenyan, Moroccan, Nigerian, and South African banks are rapidly expanding operations in the region. Over the past four years, the transformational impact of the deepening and broadening of financial system technology has become clear as well. With over 13 million clients in Kenya, M-Pesa is the world's most widely used telecommunications-led mobile money service.

Globally, too, the environment is different. We might be at the tail end of the first global financial crisis of the 21st century and the Great Recession, but the global financial system has changed dramatically. The center of economic and financial power has shifted to the South and East, which is also reflected in the replacement of the G7 by the G20 as the major international policy coordination body.

The set of information and experiences is larger

Relative to four years ago, we have a much richer and more detailed set of data available. Specifically, we can draw on a systemic data collection effort by the African Development Bank and the Deutsche Gesellschaft für Internationale Zusammenarbeit of indicators on the development and structure of financial systems across Africa, as well as the regulatory framework. Furthermore, the international community has made enormous progress in collecting data on the outreach of financial systems and the barriers to access among enterprises and households; we draw on this experience.

A critical difference with respect to the previous publication is the inclusion of the North African subregion. The inclusion of these countries—different in income level and economic and financial structure—and the comparison with other parts of Africa enrich the discussion in the book and provide additional insights into the process of financial sector deepening and broadening. The recent turmoil in this part of Africa, however, makes many conclusions on the related financial systems appear tentative.

While Africa can learn from the rest of world, the world can learn from Africa, as we lay out in this publication. The experience with mobile phone banking, for example, shows the power of technology and the potential that payment-led inclusion strategies possess relative to credit- or savings-led inclusion strategies. We therefore refer to experiences in other regions, but also experiences in different African countries and how these experiences may be used across the continent.

The focus has expanded

The altered global environment also calls for a somewhat different emphasis. In light of the recent regulatory reform debate in Europe and the United States and in the context of the

Box 1.1 What's New? (continued)

G20 process, we focus more prominently on the regulatory framework. We argue that the reform suggestions developed in response to the recent crisis have to be adapted with caution to the African context and, even within the African region, to the level of development of different financial systems.

Including North Africa also reemphasizes the benefits of focusing on differences across Africa. Thus, needs and policy options vary between small and large and between low- and middle-income countries, while landlocked, resource-rich, and fragile states face yet another set of challenges.

Honohan and Beck (2007) present two main policy recommendations: (1) strengthen credit and property registries and streamline court procedures and (2) establish independent supervisors. This publication follows a different path by presenting three main general messages, which are then fine-tuned in each of the thematic chapters and also detailed for different country groups.

Some themes and contrasts are maintained from the previous book. The contrast between the modernist and the activist approach is also used in this publication to highlight the advantages of a careful assessment of the role of government, a role that should help create and develop markets rather than replace them. We also build and expand on the distinction between Finance for All and Finance for Growth by highlighting the importance of finance for basic market transactions beyond fostering long-term investment activities.

as (1) facilitating the exchange of goods and services by providing a medium of exchange; (2) pooling society's savings for investment in large investment projects beyond the savings capacity of small individual savers; (3) screening potential investment projects, thus putting society's savings to the best use; (4) monitoring enterprises and thus making sure money is used for the best purpose; and (5) investing in risk management services, such as diversifying across different projects or smoothing volatility over time.² These functions overlay with the practitioner's distinction among (1) payment and transaction services, (2) deposit and savings services, (3) credit services, and (4) insurance and risk management services. These services are often provided by different institutions or in different markets. Yet another, partly overlaying distinction is based on different beneficiary groups and time horizons. Expanding on a distinction made by Honohan and Beck (2007), this book distinguishes between three concepts: Finance for Markets, Finance for Growth, and Finance for All. This distinction helps us frame our discussion throughout the book.

- *Finance for Markets* relates to financial services that underlie short-term commercial market transactions, such as trade finance, remittance payments, and various types of short-term credit facilities. This concept relates primarily to the financial system function of enabling market-based transactions within the economy and across borders. By facilitating commerce, financial systems allow the market-based exchange of goods and services beyond the immediate family

and community. Finance for Markets refers to financial services for enterprises and households, thus cutting across all possible beneficiary groups. The concept covers transaction and payment services, including remittances from emigrant workers to their families back home. It covers deposit services for households and enterprises, as well as short-term credit facilities for enterprises of all sizes, including trade credit. These basic services are provided by almost every financial system in the world, even the most rudimentary ones, although at different degrees of efficiency. They are mostly provided by banks, but may also be provided by nonbank financial service providers, including telecommunications companies. The recent crisis and the reduction in the supply of trade finance underline the importance of Finance for Markets.

- *Finance for Growth* relates to the finance for enterprises, households, and governments that supports medium- and long-term activities (longer than 12 months). Finance for Growth is finance mainly for investment purposes, and it is here that financial institutions and markets fulfill their key function of the maturity transformation of short-term liquid claims—be they deposits or marketable securities—into long-term investment finance. Finance for Growth thus involves a key function of financial systems: pooling society's savings and putting them to their best use. This comprises risk management techniques and the screening and monitoring of entrepreneurs and projects. It relates to large-scale finance, including for infrastructure and agriculture, and finance for small and medium enterprises and to debt and equity instruments, as well as hybrid instruments, such as mezzanine debt and guarantees. These services are provided by an array of institutions, including banks, insurance companies, pension funds, mutual funds, and private equity funds, and relate to activities on different financial markets, including stock and bond markets. Moving from Finance for Markets to Finance for Growth constitutes a major challenge for many low-income countries, including in Africa.
- *Finance for All* relates to the process of expanding financial services both for markets and for growth to the largest possible segment of the population, including households, small enterprises, and large firms. Finance for All overlaps the concepts of Finance for Markets and Finance for Growth, but refers to the process by which short- and long-term financial services, including payment, savings, credit, and insurance services, are pushed out to previously unserved segments of the population. It overlaps with Finance for Markets to the extent that access to basic transaction services is being extended to all segments of the population. It overlaps with Finance for Growth to the extent that more segments of the population gain access to contractual savings services, while microenterprises gain access to investment finance. In discussing Finance for All, we refer to all types of formal financial institutions, but also semiformal financial institutions such as cooperatives or savings and credit cooperatives. Finance for All has been a challenge throughout the world not only for low-income coun-

tries, but also for many middle-income countries that have made substantial progress in the dimensions of Finance for Markets and Finance for Growth.

The three concepts overlap, including in policy prescriptions, but it is important to keep in mind the different focus of each. Countries at different levels of economic and financial development might focus on different concepts. Postconflict or low-income economies might focus mainly on the basic services implied by Finance for Markets, and middle-income and socioeconomically more stable countries might focus on Finance for Growth strategies.³ Finance for All has remained a challenge for low- and middle-income countries and even for some high-income countries, such as the United Kingdom or the United States.

It is important to note that these three concepts do not involve a trade-off, least of all the Finance for All approach. It is more about sequencing than trading off. For instance, the existence of efficient financial services for market exchange is the basis for longer-term financial contracts.

The Main Messages and a Caveat

In Africa, distinguishing among these three concepts is critically important for policy design. While African economies and financial systems share many features, there are critical differences along notable dimensions. Financial systems face different challenges in low- and middle-income countries across the continent. Basic financial services for commercial transactions and short-term credit (Finance for Markets) characterize the financial systems of many low-income countries, where formal financial services are often limited to a small share of enterprises and households. Middle-income countries are characterized by a much larger outreach of banking systems to households and enterprises, a larger variety of financial services and products, and a diversification of financial institutions and markets. Size matters: even among low-income countries, larger economies are able to sustain larger and more diversified financial systems.

There are also important geographical differences. North African financial systems are dominated by government-owned financial institutions to a much larger extent than systems in Sub-Saharan Africa, where many systems are weighted toward foreign-owned banks. Even there, though, governments are preponderant in other segments of the financial system, such as the pension sector and the bond market. However, there are also important differences in the challenges that financial systems in densely populated economies, such as Rwanda and Uganda, face from systems in countries with more dispersed populations, such as Ethiopia or Tanzania. There is an important distinction between common law and civil code countries. Common law countries typically have a more flexible legal and regulatory framework that offers more room for innovation, while civil code countries rely more steadily on written codes and often take longer to adjust the legislative and regulatory framework to new developments. Finally, postconflict countries

and economies with abundant natural resources face their own unique set of challenges in achieving financial deepening and broadening.

We refer to these distinctions throughout the book and provide policy recommendations for the various subgroups in chapter 6.

Taking into account these large differences across the continent, we use the framework above to develop the three main messages resulting from our analysis, as follows:

- *Competition is the most important driver of financial innovation that will help African financial systems deepen and broaden.* Competition, in this context, is broadly defined and encompasses an array of policies and actions. On the broadest level, it implies a financial system that is open to new types of financial service providers, even if they are nonfinancial corporations. It allows the adoption of new products and technologies. The example of cell phone–based payment systems across the continent is one of the most powerful illustrations in this category. Within the banking system, competition implies low entry barriers for new entrants, but also the necessary infrastructure to foster competition, such as credit registries that allow new entrants to draw on existing information. To achieve more competition in smaller financial systems, more emphasis has to be placed on regional integration. However, this might also mean more active government involvement by, for example, forcing banks to join a shared payment platform or contributing negative and positive information to credit registries. While it is important to stress that the focus on innovation and competition should not lead to the neglect of financial stability, there has been a tendency in many African countries to err too much on the side of stability.
- A second and related message is that *there should be an increasing focus on financial services rather than on specific institutions.* Across all three dimensions discussed above (Finance for Markets, Finance for Growth, and Finance for All), we care primarily about the necessary financial services and, only in a second instance, about the institutions or markets that provide the services. Banks are an important component of every financial system, but if nonbanks are better at providing certain financial services, they should be allowed to do so. If the small economies of Africa cannot sustain organized exchanges, the emphasis should be placed instead on alternative sources of equity finance, such as private equity funds. If the local economy is not sufficiently large to sustain certain segments of a financial system, then the import of such services should be considered. One size does not fit all: smaller and low-income countries are less able than larger and middle-income countries to sustain a large and diversified financial system and might have to rely more heavily on international integration.
- Finally, *there is a need for increased attention on the users of financial services.* Turning unbanked enterprises and households into a bankable population and ultimately banked customers involves more than pushing financial institutions down-market. Achieving such a change requires financial literacy, that is, knowl-

edge about products and the capability to make good financial decisions among households and enterprises. It also means that nonfinancial constraints must be addressed, such as, most prominently, in agriculture. It includes a stronger emphasis on equity financing for often overleveraged enterprises. It also includes a consumer protection framework, though what suits South Africa, for example, may be too costly in resources and skills for Malawi.

Financial Sector Development: Why Do We Care?

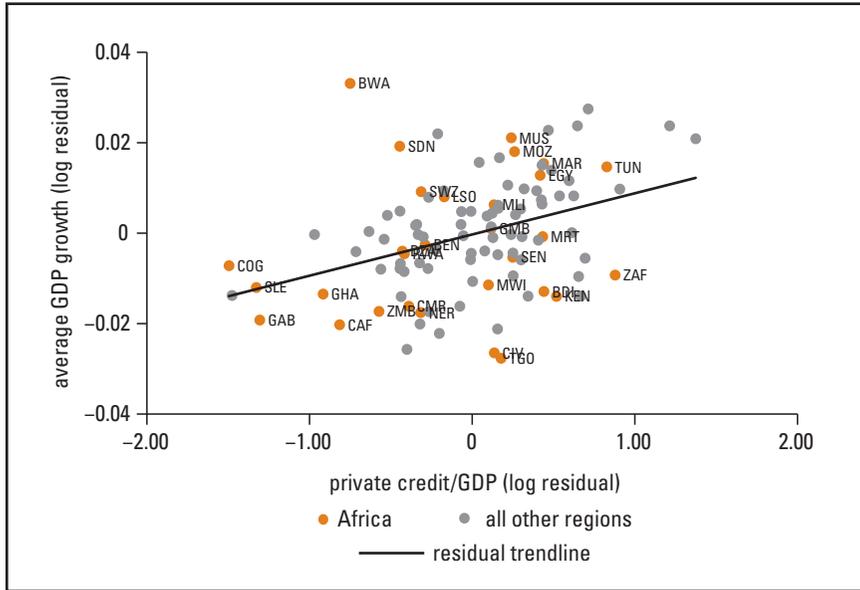
The provision of financial services for specific beneficiary groups is important, but the ultimate goal is economic development. What is the role of finance in the development process in Africa? How important is financial sector development relative to development in other policy areas? Where should the emphasis lie: in banks or markets? Broad cross-country comparisons, but also experiences in the region, have provided insightful evidence in this respect.

Ultimately, financial deepening and broadening can contribute to Africa's move out of poverty and low-income status toward middle-income and emerging market status. The vision is of a financial system that fulfills the three concepts discussed above by providing a sound and effective platform for the market-based exchange of goods and services, attracting and intermediating the necessary resources for long-term private and public investment, and expanding financial services to larger segments of the population so as to offer, at least, access to transaction services.

Two decades ago, financial system development was an afterthought in the mind of a development economist designing a policy agenda. Today, financial sector policies have become a centerpiece in the debate on how to foster growth in low-income countries, reduce stark poverty levels, and, ultimately contribute to the achievement of the Millennium Development Goals. Over this period, ample evidence based on various levels of aggregation and distinct methodologies has been accumulated on the growth-enhancing effect of financial sector development. Even accounting for reverse causation, research has established the robust positive impact of financial sector deepening on economic development. Figure 1.1 illustrates the conclusion of a well-established body of empirical evidence: countries with higher levels of credit to the private sector relative to GDP experienced higher average annual real GDP per capita growth rates over the period 1980–2007. The relationship holds not only for a broad cross-section of countries, but also within Africa. The conclusion is confirmed by cross-country, panel, and time-series estimation techniques.⁴

The effect of finance on growth is not only statistically, but also economically significant. To illustrate the effect of financial deepening, compare Ethiopia with Thailand. Over the period 1980–2007, the ratio of private credit to GDP averaged 18 percent in Ethiopia, but 87 percent in Thailand. The cross-country comparisons illustrated in figure 1.1 suggest that Ethiopia's real GDP per capita would have

Figure 1.1 Finance and Growth across Countries, 1980–2007



Source: Author calculations.

Note: Sample size: 99 countries. The figure shows a partial scatter plot of private credit to GDP and GDP per capita growth averaged over 1980–2007 and controlling for initial GDP per capita, government consumption, inflation, trade openness, and education. For a complete listing of 3-letter country codes and the respective country names, see pages xvi–xvii.

grown by 1.3 percentage points more had the country been at the same level of financial development as Thailand, or 1.4 percent instead of the actual 0.1 percent. Under this scenario, GDP per capita would have been over 40 percent greater in 2007.⁵ We can also compare the financial development and corresponding growth performance in Africa with that in low- and middle-income countries in East Asia. While financial development measured according to the ratio of private credit to GDP stood, on average, at 21 percent across Africa over the period 1980–2007, it was 32 percent in East Asia. During the same period, the East Asian economies grew 2.3 percent per year on average, while the African economies grew 0.7 percent on average. The estimates illustrated in figure 1.1 suggest that 0.4 of a percentage point of this difference in average annual growth—a quarter of the difference—was caused by the lower level of financial development. Thus, the estimates suggest that, today, Africa could have a GDP per capita greater by 13 percent than the actual GDP per capita. This is, indeed, a significant loss.

The positive impact of financial development on growth does not mean that growth has no influence on financial deepening and broadening. On the contrary, by helping to increase incomes, financial deepening can create additional demand for financial services, thus generating a positive feedback loop. Policies that help

foster financial sector development ultimately also help establish a virtuous growth cycle. Moreover, many of the policies that foster financial sector deepening and broadening, including an effective contractual and information framework and macroeconomic stability, also have a direct positive impact on economic development and poverty alleviation.

What are the channels through which financial development helps increase economic growth? While financial systems assist in pooling savings, transforming maturity, and converting savings into capital accumulation, it is ultimately through improvements in resource allocation and productivity growth that finance helps economies grow more quickly (Beck, Levine, and Loayza 2000; Love 2003; Wurgler 2000). The functions of attracting deposits and investment and transforming short-term claims into long-term assets, thereby financing investment, should obviously not be ignored; they are the basis for the ultimate function of finance, which is to put the savings of society to the best use, that is, put savings where they can reap the highest (expected) returns, thus translating into growth. Financial deepening especially helps industries that rely heavily on external finance, but it also helps reduce the financing constraints on enterprises, particularly smaller firms (Rajan and Zingales 1998; Beck, Demirgüç-Kunt, and Maksimovic 2005). Financial deepening thus has a transformative effect on economies by shaping industrial structure, distribution by firm size, and even organizational structures (Demirgüç-Kunt, Love, and Maksimovic 2006). It is the facilitating role of financial systems that helps foster economic growth. Finance provides opportunities for new entrepreneurs and fosters innovation and competition as well.

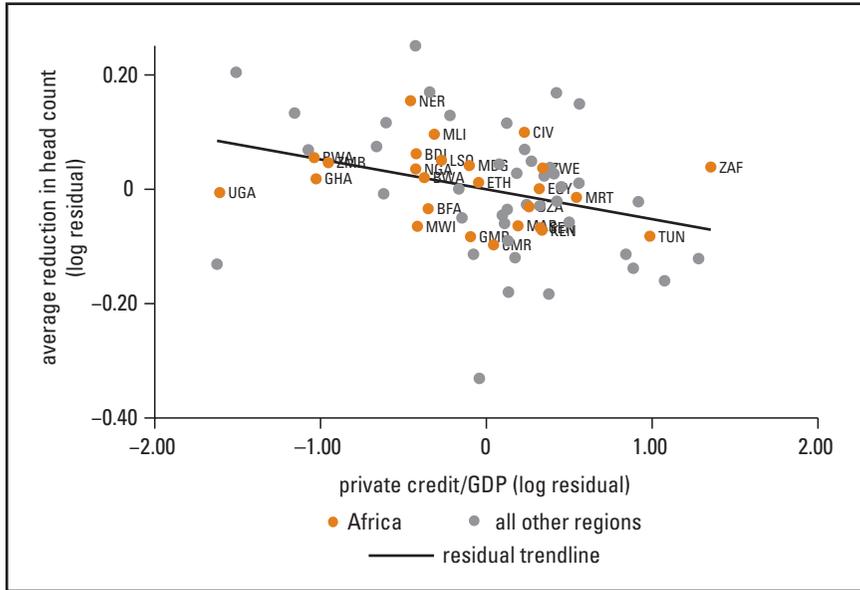
Providing external finance to enterprises in the form of equity, debt, or some hybrid thus seems critical to the positive impact of finance on growth. Recent cross-country comparisons have indeed found that it is enterprise credit, rather than household credit, that explains the positive impact of finance on growth (Beck et al. 2009). This does not mean that credit services for households are not important; the growth effect of financial development, however, seems to come mainly from enterprise finance. One therefore has to look beyond credit services to other financial services in discussing the welfare impact of financial service provision on households. This casts doubt on the credit-led inclusion strategy often propagated by microcredit institutions and puts a premium on enhancing access to savings and transaction services. We return to this topic in chapter 3.

Financial sector development is important not only for fostering the economic growth process, but also for dampening the volatility of the growth process. As shown by Aghion et al. (2010), financial systems can alleviate the liquidity constraints on firms and facilitate long-term investment, which ultimately reduces the volatility of investment and growth. Similarly, well-developed financial markets and institutions can help dampen the negative impact that exchange rate volatility has on firm liquidity and thus investment capacity (Aghion et al. 2009). This is especially important in economies that depend heavily on natural resources and are thus subject to high terms of trade and real exchange rate volatility.

What has the recent crisis taught us about the importance, but also the risks of financial deepening?⁶ First and foremost, it has shown us the enormous risks that financial system fragility can create in the overall economy and for people's livelihoods. The global crisis and the ensuing Great Recession have put in doubt the paradigm that financial deepening is good for growth under any circumstance. Consumer credit booms in several European countries and the United States, fueled by the combination of regulatory neglect, the feeling that "this time is different," and the liquidity glut linked to global macroeconomic imbalances, ended in the global financial crisis. International links through global financial markets helped propagate the shock, first, through financial markets, while trade links ultimately resulted in the propagation of the real sector slump. For students of financial systems, the bright (growth-enhancing) and dark (instability) sides of financial development go hand in hand. The same mechanism through which finance helps growth also makes finance susceptible to shocks and, ultimately, fragility. Specifically, the maturity transformation from short-term savings and deposit facilities into long-term investments is at the core of the positive impact of a financial system on the real economy, but also renders the system susceptible to shocks. The role that finance has as a lubricant for the real economy likewise exacerbates the effect of financial fragility on the real economy. However, the externalities that the failure of financial institutions and markets impose on the real economy and the heavy government support for incumbent financial institutions that financial fragility therefore typically triggers are taken into account by the stakeholders in financial systems and give these stakeholders an incentive to be aggressive in the face of risks. It is thus critical to harness financial market forces for the benefit of the real economy and the population at large, rather than focus on finance for its own sake.

Instead of throwing out the baby with the bathwater, it is therefore important to construct a regulatory and governance framework that minimizes the risk of fragility and provides policy makers with better possibilities for managing bank failures in a way that is incentive-compatible. If there is a lesson to be learned in Africa from the crisis, it seems to be that the growth benefits of a well-developed financial system can only be reaped in a stable macroeconomic environment protected by an appropriate regulatory and supervisory framework and strong internal bank governance. This means there should be more transparency and accountability in bank management, less direct government intervention in the regulatory and supervisory process, and a focus on building up mechanisms of market discipline. However, the situation also highlights the demand-side constraints in terms of financial literacy and consumer protection, a topic we take up in several parts of the publication.

Ultimately, the financial systems of Africa are significantly less sophisticated than systems elsewhere, and most are far from becoming overheated as several financial systems in Europe and North America did before the crisis. This does not mean that there is no fragility (see chapter 5). Nonetheless, most of the fragility in recent years has not arisen because of too much finance, but because of misallocated finance generated by governance challenges. In a nutshell, Africa's financial

Figure 1.2 Finance and Poverty Alleviation across Countries

Source: Beck, Demirgüç-Kunt, and Levine (2007).

Note: Sample size: 68 countries. The figure shows a partial scatter plot between the ratio of private credit to GDP and growth in the headcount—the share of the population living on less than a dollar a day—averaged over the period 1980 to 2003 and controlling for the initial headcount. For a complete listing of 3-letter country codes and the respective country names, see pages xvi–xvii.

systems stand to gain significantly from deepening and broadening. If there is a decreasing marginal benefit from financial deepening or even a threshold where more financial deepening may have a negative effect, Africa's financial systems are far from reaching it.⁷

Who benefits the most from financial deepening? While theory provides conflicting analyses about whether it is the rich or the poor who benefit most from financial sector development, cross-country comparisons indicate that financial deepening has a pro-poor effect (Beck, Demirgüç-Kunt, and Levine 2007). Figure 1.2 illustrates the pro-poor effect of finance: countries with deeper financial systems see poverty levels drop more rapidly. As in the case of economic growth, the economic effect of financial deepening on poverty reduction is strong. Again, a comparison between Ethiopia and Thailand illustrates. Specifically, the cross-country comparisons shown in figure 1.2 suggest that, instead of a reduction in the poverty headcount from 33 to 23 percent over the period 1981 to 2000, a level of financial development similar to that of Thailand would have allowed a reduction of the headcount to 9 percent in Ethiopia.⁸

Financial deepening can have broader effects on socioeconomic development than those captured by GDP per capita and the poverty headcount. While eradicat-

ing extreme poverty by 2015 is one of eight Millennium Development Goals adopted in 2000, financial development may also be linked to the other seven goals, which refer to education, gender equality, health, the environment, and global partnerships.⁹ In the case of education and health, one important outcome of access to financial services occurs through the income effect: better access to financial services improves incomes and therefore the possibility of accessing health and education services, while, at the same time, reducing the need to rely on children as laborers in the household. Allowing women direct access to financial services might improve the possibility they could become entrepreneurs, thus increasing their individual incomes and their chance to be more independent. This is reflected in greater female participation in family and community decision making. There is also an important insurance effect: better access to credit, savings, or insurance services reduces the need to use child labor as a buffer in the case of seasonal income fluctuations and transitory income shocks and allows consumption smoothing in the case of transitory income reductions caused by health shocks. It also allows more rapid attention to health problems. Finally, there is an aggregate infrastructure effect: more efficient financial institutions and markets allow more private and public investment in the construction of schools and health facilities.

What are the mechanisms of this poverty-reducing impact of financial deepening? Theory suggests different channels. On the one hand, providing access to credit among the poor might help the poor overcome financing constraints and allow them to invest in microenterprises and human capital accumulation (Galor and Zeira 1993; Galor and Moav 2004). On the other hand, there might be indirect effects through enterprise credit. By expanding credit to new and existing enterprises and allocating society's savings more efficiently, financial systems can expand the formal economy and pull larger segments of the population into the formal labor market. The first explorations of the channels through which finance affects income inequality and poverty levels point to an important role for such indirect effects. Specifically, evidence from Thailand and the United States suggests that an important effect of financial sector deepening on income inequality and poverty is an indirect one. By changing the structure of the economy and allowing more entry into the labor market by previously unemployed or underemployed segments of the population, finance helps reduce income inequality and poverty, but not by giving access to credit to everyone (Beck, Levine, and Levkov 2010; Giné and Townsend 2004). It is important to stress that this is preliminary evidence to be confirmed or refuted by future research, but it has centered the debate on an important question: should policy makers focus on deepening or on broadening financial sectors? It has also helped widen the debate on financial services for the poor beyond microcredit to other financial services, such as savings services, payment services (especially in the context of remittances from family members who have emigrated to other parts of the country or outside the country), and insurance services.¹⁰

A long-running discussion has centered on whether policy makers should focus more on banks or on capital markets. While both provide important financial ser-

vices, the related technologies are different. Banks create proprietary information about their clients, especially borrowers, while capital markets collect and process information from different sources and reflect this information in prices. Banks offer better intertemporal risk diversification tools, while markets are better in diversifying risk cross-sectionally. Markets are better at offering standardized products, while banks are better at offering tailored solutions. However, banks and markets can also be complementary through the application of instruments such as securitization, by allowing exit strategies for venture capitalists, and by providing competition with each other. However, cross-country comparisons have shown that it is not really the structure of the financial system that matters, but rather the provision of financial services, whether these are supplied by banks or markets (Levine 2002; Beck and Levine 2002; Demirgüç-Kunt and Maksimovic 2002). The attempts of policy makers to push artificially for the development of a specific segment of the financial system over another are typically not fruitful. Yet, comparing financial systems across countries, one can discern clear patterns. Such a comparison suggests that there is an ordering in the development of different segments of the financial system. Systems in low-income countries are typically based much more on banks, while capital markets and contractual savings institutions, such as insurance companies, develop at a later stage.¹¹ Beck et al. (2008) estimate an income elasticity for different components of the financial system, which illustrates the different speeds at which different segments develop as GDP per capita rises (see table 1.1). Given the level of GDP per capita on the continent, it is not surprising that all African financial systems are based heavily on banks and exhibit underdeveloped markets. Not only is the capital market segment of these financial systems underdeveloped, but also the contractual savings component (insurance, pensions, and mutual funds) is small in most African countries. Finally, there is a

Table 1.1 Income Elasticities across Different Segments of the Financial System

Variable	Rank	Income elasticity
Public bonds to GDP	1	0.20
Bank deposits to GDP	2	0.35
Bank assets to GDP	3	0.44
Pension funds to GDP	4	0.45
Bank credit to GDP	5	0.49
Stock market capitalization to GDP	6	0.56
Insurance assets to GDP	7	0.66
Institutional investor assets to GDP	8	0.77
Mutual funds to GDP	9	0.88
Private bond capitalization to GDP	10	1.20
Value traded to GDP	11	1.30

Source: Beck et al. (2008).

scale element to the development of capital markets, and small economies therefore have difficulty—even in the developed world—in sustaining liquid markets.

The above discussion does not imply that policy makers in Africa should be content with the underdeveloped nonbank segments of the financial system. There is a need to diversify the financial center away from a heavily bank-dominated system, but it is also important to recognize that artificially creating certain components of the financial system without the necessary demand and infrastructure will have limited economic benefit.

Time for New Solutions to Old Problems

Financial institutions and markets exist to help overcome market frictions related to transaction costs and risk. However, the efficiency with which financial institutions and markets can overcome these market frictions is critically influenced by country characteristics. Fixed transaction costs in financial service provision result in decreasing unit costs as the number or size of transactions increases. These fixed costs exist at the level of the transaction, client, institution, and even financial system. Processing an individual payment or savings transaction entails costs that are, at least in part, independent of the value of the transaction. Maintaining an account for an individual client also implies costs that are largely independent of the number and size of the transactions the client makes. At the level of a financial institution, fixed costs span a wide range—from the brick-and-mortar branch network to computer systems, legal and accounting services, and security arrangements—and are independent of the number of clients served. Fixed costs also arise at the level of the financial system, including regulatory costs and the costs of payment, clearing, and settlement infrastructure, which are, up to a point, independent of the number of institutions regulated or participating in the payment system. The resulting economies of scale at all levels make it unprofitable to stay in the business of financial service provision unless the associated scale economies are captured in some form.¹²

In addition to costs, the outreach in the supply of financial services, especially credit and insurance services, is constrained by risks, particularly the risk of default. The risks can be either contract specific or systemic. Systemic risk can be defined as risk that is nondiversifiable within a given economy and that, as a consequence, affects all financial contracts. Systemic risk typically stems from high macroeconomic uncertainty (reflected in high inflation and exchange rate volatility), weaknesses in the contractual and informational environment, or geographical limitations. Regardless of its origin, systemic risk hinders the supply of financial services because it raises the default probability or the loss, given default, for all contingent contracts written in a given jurisdiction. This leads to a higher cost for funds and, hence, a higher floor for the interest rate required to grant a loan, shorter maturities as risk increases with the loan horizon, or higher premiums to write insurance policies. As systemic risk increases, it enlarges the set of borrowers and projects that find the cost of credit unaffordable and are thus priced out of the

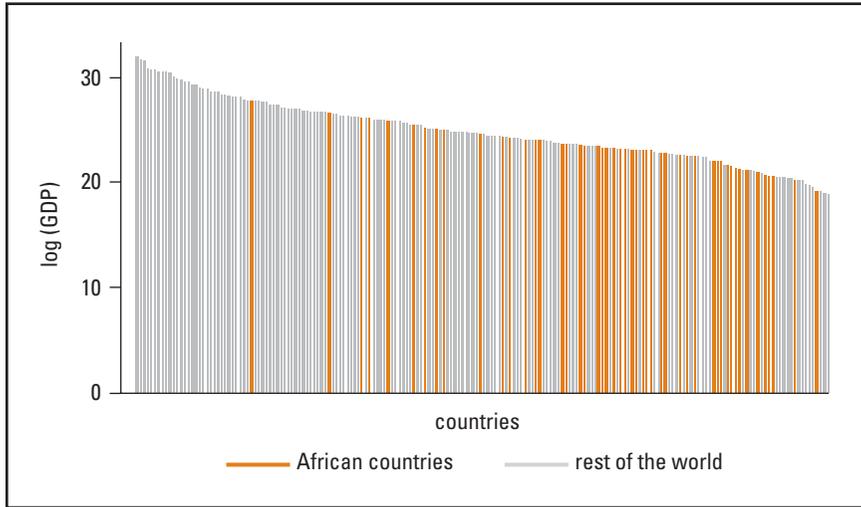
credit market. Similarly, this makes insurance policies unaffordable for larger segments of the population.

Idiosyncratic credit risks are specific to individual borrowers or projects and therefore are not correlated with systemic risk. As a result, the cost of finance and the availability of credit or insurance services differ across debtors and projects depending on the related differences in idiosyncratic riskiness. Importantly, however, the ability of the lender to manage idiosyncratic risk is influenced by the systemic risk environment. Two factors are particularly important in explaining the differences in interest spreads across debtors (for a given type of loan) that are induced by idiosyncratic risk: agency problems and limits to the diversification of risks that are not related to agency problems. The first can be linked to the lack of information, but also to volatility, while the second can be linked to diseconomies of scale. Agency problems arise from information asymmetries between debtors and creditors, whereby a debtor is privy to relevant information about herself and her project that the creditor may not be able to secure or only at a prohibitively high cost; this can lead to two conceptually distinct sources of credit risk: adverse selection and moral hazard.¹³ The former refers to higher interest rates that attract riskier borrowers and projects, while the latter refers to the borrower's incentive to use the proceeds of the loan in endeavors that are riskier than those specified in the credit contract, while concealing this behavior from the creditor.

A lack of scale and a lack of tools to deal with idiosyncratic and systemic risk can limit the capacity of financial systems to effectively serve the host economy, foster growth, and reduce poverty. However, the characteristics of the host economy provide the backdrop before which financial institutions and markets have to operate. African economies are characterized by several adverse circumstances—pointed out by Honohan and Beck (2007)—that make it more difficult to overcome the two market frictions of size and risk, as follows:

- The *small scale* of many economies does not allow financial service providers to reap the benefits of scale economies. The small size of African economies, as shown in figure 1.3, is driven by the low income level across the continent, but also by the small size of countries. The limited demand for savings, insurance, credit, or even simply payment transactions means that large parts of the population of African economies are not commercially viable customers. The dispersed populations in many African countries means that financial service provision outside urban centers is not cost-effective. Despite the increasing trend toward urbanization, large parts of populations in Africa still live in rural areas. The small size of financial systems does not allow financial institutions to recover the fixed costs of basic systems and might undermine competition if the system does not sustain more than a small number of institutions.
- As documented in figure 1.4, large parts of the economy and a large share of all economic agents operate in the *informal sector* and do not have the necessary formal documentation, such as enterprise registration, land titles, or even formal

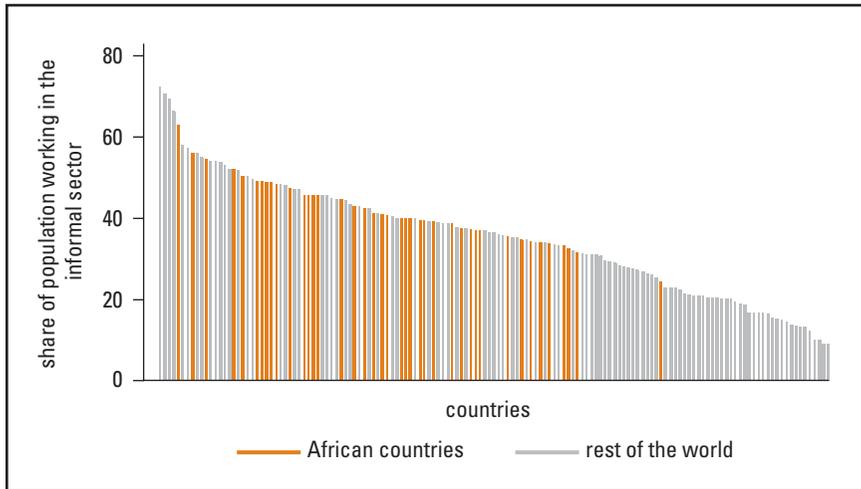
Figure 1.3 GDP across Countries, 2009



Source: World Bank (2010a).

Note: Sample size: 188 countries. GDP is measured in current U.S. dollars.

Figure 1.4 The Informal Economy across Countries, 2007

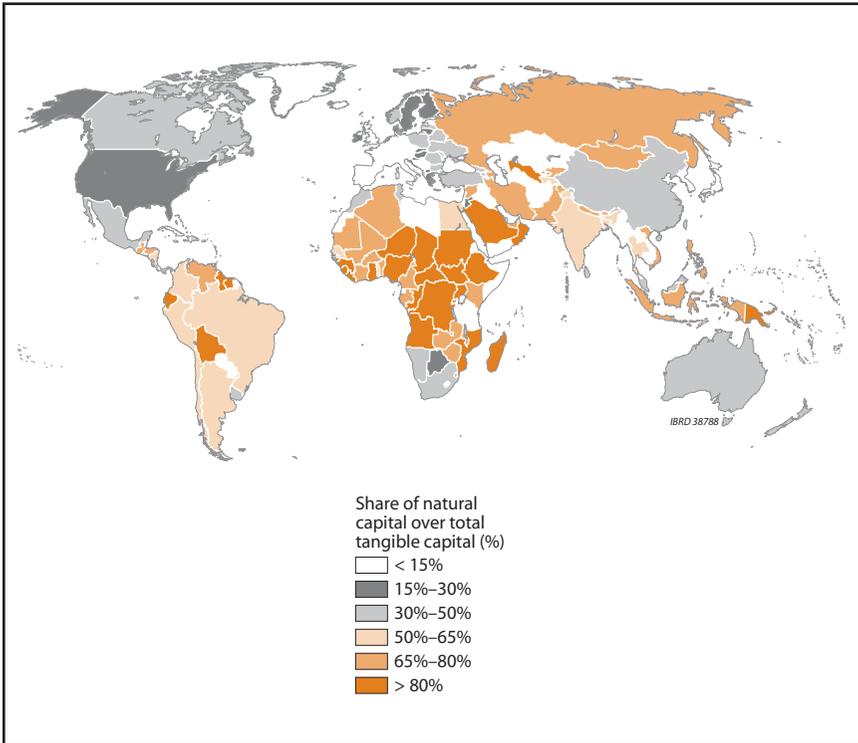


Source: Schneider, Buehn, and Montenegro (2010).

Note: Sample size: 145 countries.

addresses. This increases the costs and risks for financial institutions and excludes large segments of the population from formal financial services.

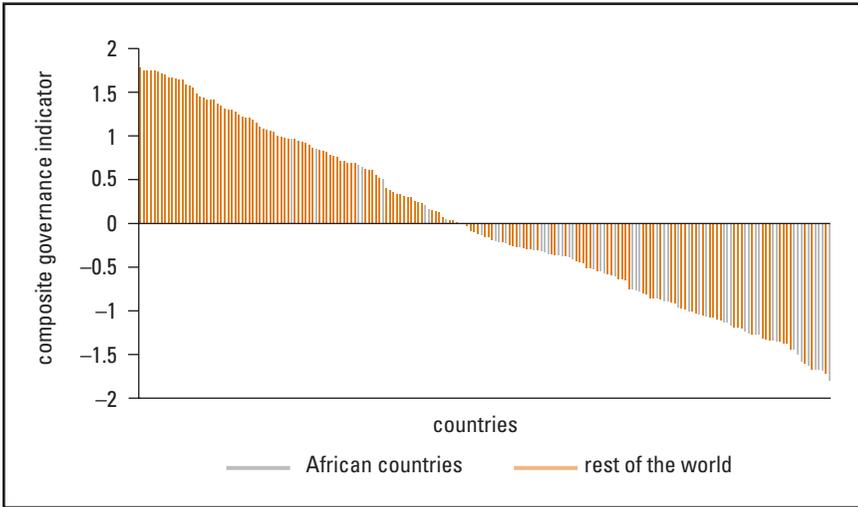
- *Volatility* on the individual and aggregate levels increases costs and undermines risk management. At the individual level, volatility is related to informality and

Map 1.1 Reliance on Natural Capital across the World

Source: Gylfason (2010).

the consequent fluctuations in the income streams of many microenterprises and households. This means these agents are less attractive for financial institutions. At the aggregate level, volatility refers to the dependence of many African economies on commodity exports, which makes economies vulnerable to the large price swings characteristic of commodities (see map 1.1). Volatility at the aggregate level also refers to political and social unrest, from which Africa has suffered over the past 50 years of independence. Volatility increases the costs, but especially the risks faced by financial institutions and markets.

- **Governance** problems continue to plague many private and government institutions throughout the continent and undermine not only the market-based provision of financial services, but also reform attempts and government interventions aimed at fixing market failures. These governance challenges are widespread and affect many financial institutions, ranging from banks, microfinance institutions, and cooperatives to government institutions, including development finance institutions. Governance problems have been at the root of many financial crises on the continent. They also affect directly the ability of financial institu-

Figure 1.5 Governance across Countries, 2008

Source: Kaufman, Kraay, and Mastruzzi (2009).

Note: Sample size: 197 countries.

tions and markets to manage idiosyncratic and systemic risks. The governance challenge and the related agenda contain a large number of dimensions, ranging from political stability and accountability in the control of graft to the rule of law. Along all these dimensions, Africa ranks significantly below other countries, although there are positive examples of reforms (figure 1.5).

Not all countries show these four characteristics. Africa has large economies, such as Kenya and Nigeria. Middle-income countries such as Mauritius and South Africa are able to benefit from their higher income levels in terms of scale economies. The prevalence of the informal economy is significantly lower in the middle-income countries of North Africa than in Sub-Saharan Africa. Noncommodity exporters are subject to much less volatility than commodity exporters, and countries such as Botswana and Mauritius have shown significant and increasing levels of governance. However, many countries across the continent are affected by at least one of these characteristics, which make them less receptive to hosting a thriving financial system.

In analyzing the long-standing challenges described above, the book draws attention to three recent trends and phenomena—globalization, regional integration, and technology—that offer new solutions, but also represent new challenges.

- *Globalization*: Integration in international financial markets has been an important, but controversial aspect of financial sector policy throughout the world in past decades and even more so since the recent crisis. While most African coun-

tries have opened up their financial systems to the entry of foreign banks, capital account restrictions are still in place in many countries, although often more de jure than de facto. Capital account liberalization has long been considered an important component of the modernist agenda of the Washington Consensus (Rodrik 1998). Yet, the crisis experience in East Asia and other emerging markets in the 1990s has led to a more cautious approach. The underlying economic model has also faced severe criticism: cross-country comparisons do not yield consistent results on the benefits of capital account liberalization. In addition, there may be a threshold value in economic, institutional, and financial development below which countries do not benefit from capital account liberalization because capital inflows critically depend on financial markets and institutions.¹⁴ Foreign investors need capital markets to invest in equity or debt, unless they create subsidiaries or joint ventures. Even portfolio investors need institutions or markets in which to invest. Governance is therefore important so that countries may reap the benefits of international capital flows, as shown by the example of resource-based economies in which the corresponding capital inflows are not always properly accounted for or used in the public interest. Overall, a cautious approach is called for that focuses more on long-term capital inflows (foreign direct investment) rather than short-term portfolio flows and that imposes additional safety lines on macroeconomic management. This debate has gained fresh significance in light of the current attempt of emerging markets to use capital flow restrictions to counter the negative repercussions of the capital inflows from developed markets that are a consequence of the application of quantitative easing policies.

- *Regional integration*: Regional integration has been on the agenda of African policy makers since many countries achieved political independence. The successful example of Europe in creating a large regional market with a joint currency, joint institutions, and coordinated policy making has been inspiring, although the recent euro crisis may have dampened the enthusiasm somewhat. Prima facie, there is an enormous potential for Africa in overcoming scale diseconomies by coming together. Not surprisingly, there have been numerous attempts at such cooperation. However, the results have been limited. Apart from three currency unions, two joint bank regulation and supervision authorities, a joint insurance regulatory authority, and two regional stock exchanges, most efforts have occurred at the level of coordination and the exchange of experiences. One reason for the limited success at integration has been political; another is overambition, as is obvious from the failure to establish a pan-African currency union; yet another is weak implementation. It is important to note that—as in the European Union—regional integration cannot and will not move at the same speed in all areas and all segments of the financial sector. For this reason, focusing on smaller and economically and institutionally more homogeneous subregions, such as East Africa, might be more promising than trying to integrate larger regions with countries at different

levels of financial development and relying on different institutional and legal structures. By harmonizing the bank regulatory framework, authorities can reduce the regulatory costs for banks active across several countries of the respective subregion (World Bank 2007a). Integrating payment systems can significantly reduce the cost of crossborder transactions, including remittances, and help increase intraregional trade. Creating regional stock exchanges and allowing cross-listing can assist in creating the necessary scale for liquid capital markets in the region.

- *Technology*: Technology can help mitigate scale- and risk-related frictions. Technology can help reduce transaction costs, especially the fixed cost component. It can help reduce operational risk, while it minimizes the opportunities for theft and fraud. Financial services via mobile phones offer African financial systems the chance for a transformational banking model that leapfrogs conventional banking models by substantially reducing transaction costs. Moving away from the brick-and-mortar model of banking with high fixed costs toward mobile phone technology, where most of the costs are variable, can help overcome diseconomies of scale. Similarly, weather insurance built on exogenous indicators can help resolve information asymmetries between the insured and insurance companies at low cost.

Globalization, regional integration, and technology offer new opportunities, but also represent challenges, which we discuss throughout the book. All three trends will also have an impact on the relative role of the private and public sectors. There will be more space for private service providers to deepen and broaden financial systems, while the public sector has to redefine its role and face new challenges in regulation and supervision. Globalization, regional integration, and technology will raise new challenges to financial sector regulators. Globalization and regional integration will require home and host country regulators to cooperate more closely in regard to crossborder banks, and these home and host countries will increasingly be outside the developed world. Technology, especially in mobile financial services, will require closer cooperation among regulators across sectors, but also a more agile regulatory approach.

The changes in globalization and the new opportunities that technology provides also raise new challenges for governments. The crisis has reinforced the need for an open debate on the role of government. Honohan and Beck (2007) address this debate by distinguishing two approaches to financial sector policy: *modernism* and *activism*. While modernism focuses on creating the necessary conditions for the emergence of modern financial markets, including the necessary legal and regulatory reforms, activism aims at replacing nonexistent markets through government intervention, including government-owned financial institutions.

Many elements of this debate are reflected in this book as well. The recent crisis might trigger an increasingly activist role for governments throughout the continent, partly driven by the examples set in industrialized countries, but also by the

different role of government in Brazil, China, and India, three emerging countries with growing influence and weight in Africa. This trend toward an activist role of government can also be seen in the desire of African governments to establish new development banks. Still, the memories of activist failures are too fresh to expect a full-fledged return to government-dominated financial systems. However, the limitations of the modernist approach are also evident.

As Honohan and Beck (2007) emphasize, we, too, stress a nuanced view that recognizes the limitations of modernism while pointing to the pitfalls of activism. Government has to play an important role in (1) expanding outreach, (2) lengthening financial contracts, and (3) safeguarding financial systems. This role goes beyond setting the rules of the game and building institutions. Government might have to play an important part in fostering competition, but also cooperation. The important message is that one size does not fit all; while learning from other countries in the region and other regions is important, the contextual framework has to be stressed. We are also far from possessing a rigorous metric that can be used to categorize and judge government interventions; there will be a lot of trial and error. It is thus important to put in place better assessment tools for government interventions.

The Outline of the Book

The remainder of the book is organized into five chapters. In the next chapter, we landscape financial systems in Africa. We use an array of (new) data on the country, firm, and household levels to quantify the development and structure of financial systems across the continent. We show that Africa's financial systems continue to be small in absolute and relative terms. They are based heavily on banks; few stock markets have sufficient liquidity; and the contractual savings industry is small and weak in most countries. The small size of financial systems also explains the high costs of intermediation and financial service provision, as well as the limited competition. The chapter also documents the progress Africa's financial systems made before the crisis and recent trends since the crisis. Africa's banking systems are well integrated in global financial systems, as shown by the dominance of many banking systems by foreign-owned banks. However, the face of globalization has changed in Africa: the multinational banks of the former colonial powers have been slowly replaced in importance by regional banks based in southern and western Africa, while capital flows from emerging markets such as Brazil, China, and India have slowly overtaken the capital flows of the industrialized world. Access to financial services by households and enterprises is still limited across Africa, though recent trends are promising.

Chapter 3 focuses on the challenge of expanding financial systems in Africa. We build on the issues of scale and risk introduced in this chapter to derive the concept of an access possibilities frontier. This provides a framework for benchmarking access to formal financial services and discussing policies that help turn the unbank-

able into the bankable population and the bankable into the banked population. We then focus on four specific dimensions of the access agenda. First, we discuss the role of different financial service providers, and, in line with our main messages mentioned elsewhere above, we focus on the importance of competition in alleviating supply-side constraints. Second, we discuss the need to concentrate on users of financial services as much as on suppliers through financial literacy programs. Third, we discuss the possibilities and challenges that technology represents in the need to promote an expansion in access. In this context, we discuss the possibility that a new transaction-led approach toward financial inclusion might be more promising in Africa than a credit- or savings-oriented approach. We discuss the role of government in pushing the frontier outward through institution building, as well as in pushing toward the frontier by fostering competition. We also focus on specific sectors, such as the ongoing challenges of agricultural and rural credit and the challenges of finance for small and medium enterprises.

Chapter 4 focuses on the issue of lengthening financial contracts. Financial services for households and enterprises are characterized by short maturities. At the same time, Africa faces enormous gaps in infrastructure, housing, and long-term firm finance. We discuss the current landscape among providers of long-term resources, including banks and capital markets, as well as institutions with unused potential to contribute to long-term finance, such as contractual savings institutions. We explore the possibilities that globalization offers in the form of sovereign wealth funds and private equity funds. We offer policy options for expanding long-term finance by adopting a similar approach as in the previous chapter and distinguishing between policies that help Africa optimize the current possibilities to expand long-term finance—partial risk guarantee schemes, public-private partnership structures, and the use of development finance institutions, among others—and policies that push the frontier outward, such as policies aimed at macroeconomic stability and institution building.

Chapter 5 focuses on safeguarding finance. Africa has made enormous progress over the past 20 years in improving the regulation of banking, with the result that financial systems are much more stable. However, progress in banking regulation has not always been accompanied by progress in the quality of supervision. Furthermore, the recent crisis has reinforced the lesson that safeguarding a financial system requires constant updating and adaptation to new circumstances. The relevance for Africa of the regulatory reform in the North, including Basel III capital requirements, are discussed. One specific issue we focus on is bank resolution and crisis preparedness, an area where there is a significant need for reform, especially in view of the increase in regional integration in banking. Expanding the regulatory and supervisory perimeter beyond banking has to be undertaken carefully, distinguishing between segments in which the savings of the poor may be at risk and in which there is a call for regulatory oversight and segments with sophisticated investors in which a caveat emptor approach might be more appropriate. Governance challenges are as important as regulation, especially in the contractual savings seg-

ment of the financial system. User protection, however, is as important as the supervision of suppliers, and we therefore discuss issues of consumer protection.

Chapter 6 is the “who does what” chapter, highlighting the role of different stakeholders. It focuses on the facilitating role of governments and the changing role of state-owned financial institutions. It also highlights the potential for regional integration in Africa and how to go about achieving it. It discusses the politics of financial sector reform and the challenge of the creation of a constituency for financial sector reform. Finally, we revisit a theme developed throughout the book—one size does not fit all—by discussing challenges and priorities among certain subgroups of countries.

Notes

1. The BRIC countries are Brazil, the Russian Federation, India, and China.
2. See Levine (2005) for an in-depth discussion.
3. This does not imply that postconflict countries do not have enormous funding needs; however, their financial systems may not be the best conduit for the funding of reconstruction efforts.
4. See Levine (2005) for a literature review. It is important to note that, while figure 1.1 illustrates a partial correlation, numerous studies using different aggregation levels have shown that this relationship is robust to controls for reverse causation and biases arising from the omission of other potential factors influencing growth.
5. Such comparisons are only illustrative because the coefficient estimates measure marginal changes rather than large discrete changes.
6. Among many others, see the following on the recent financial crisis: Acharya and Richardson (2009), Brunnermeier (2009), Levine (2010), Rajan (2010), and Stiglitz (2010).
7. A recent paper by Arcand, Berkes, and Panizza (2011) shows that, above a threshold of private credit to GDP of 150 percent, the effect of finance on growth is significantly negative.
8. As in the case of figure 1.1, the significant relationship between finance and poverty reduction illustrated in figure 1.2 is only a partial correlation, but is confirmed if one controls for reverse causation and the omitted variable bias.
9. See Claessens and Feijen (2006) and Littlefield, Morduch, and Hashemi (2003) for a closer discussion.
10. For an in-depth discussion of these issues and the relevant literature, see World Bank (2008a).
11. This is also consistent with theory; see, for example, Boyd and Smith (1998).
12. See Beck and de la Torre (2007) for a more detailed discussion.
13. For the classic article on the effects of information asymmetry on credit supply, see Stiglitz and Weiss (1981).
14. See Kose et al. (2009), and, for a discussion on Uganda, see Kasekende (2001).

