The World Bank
Africa Region

MAKING FINANCE WORK FOR AFRICA

A preview of the World Bank Report to be published in late 2006

With the prospect of more investable funds, effective finance is more necessary than ever in Africa. Making Finance Work for Africa takes stock of the current state of Africa's financial systems, both at the large scale ('finance for growth') and the small scale ('finance for all'). It critically examines prevailing wisdom on financial sector policy. While accepting the validity of a broad range of the policy building blocks that are generally recommended to create the enabling environment for effective finance (notably along legal and informational dimensions), the study also challenges the applicability to Africa today of some conventional views on a range of issues from securities market and banking regulation to the organization of microfinance institutions.

Strengthened by reforms of recent years, **things are moving in African finance**. Financial systems have begun to diversify their activities, deepen their lending and increase their reach with new products and new technologies. Credit growth is underway after a long pause, there is new entry of banks, and the reach of micro-finance is growing steadily. There has been extensive privatization of state-owned banks – often to foreign-owned banks – and many of the new entrants into financial intermediation are focused on SME and micro-finance.

However, despite the reforms, Africa's financial systems are still **mostly shallow** and **access is limited**—especially in rural areas. Even where banks have mobilized funds, they often seem reluctant to lend them. African business people complain more than other regions about the cost of finance and the difficulty of accessing it.

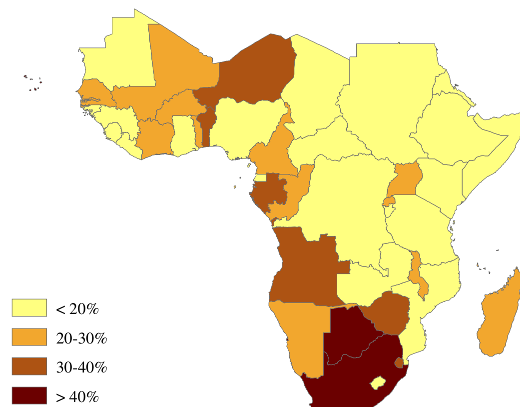
Making Finance Work for Africa takes the view that **finance could be a leading sector in transforming African economies**. As they have clearly done in many other parts of the world, efficient and innovative domestic financial systems could put African countries on a stronger and sustainable growth path—opening-up business opportunities to a wider clientele, and channeling larger resources more effectively. By providing an alternative to government patronage as the basis for entry into business activities, a strong, independent financial system can transform the business environment. In addition, finance can help the poor and in remote regions by providing small-scale payments, savings and risk reduction services.

"Things are moving in African finance: credit growth is underway after a long pause, there is new entry of banks, and the reach of microfinance is growing steadily."

There are enough recent success stories at the macro and micro level in Africa to demonstrate that this is possible. **Africa needs more energetic financial entrepreneurs**, prepared to take on the investment banking, venture capital and relationship banking challenges. New technologies – using cellphones, internet and also new financial techniques – that have proved effective in isolated pilots on the continent need to be rolled-out more widely.

Any reformer of African finance needs to have an eye on two rather different dimensions. First, the financing needs of sustained economic growth based on convergence towards high productivity of production. Second, catering for the immediate

Sub-Saharan Africa: Access to Finance by Households



needs of poor households and microenterprises. The needs of "finance for growth" and "finance for all" do not conflict, but they do require somewhat different skill sets and policy emphasis.

Two contrasting approaches to improving Africa's financial systems are commonly observed: the modernist and the activist. Both have merits, but – as is shown in *Making Finance Work for Africa* -- both tend to excess. An ideal approach is a pragmatic and context-specific mixture of each.

The *modernist* approach advocates transplanting 'best practice' from advanced economies. There is an emphasis on better legal protection for creditors, releasing the potential of land as a collateral, improving credit information, tightening stock exchange rules, strengthening prudential supervision of banks, including anti-money laundering, and countering the financing of terrorism, and liberalizing entry.

However, some **modernists are inclined to overreach,** neglecting real world constraints. For example over-enthusiasm for the latest techniques in bank regulation could misfire badly. And it is arguable that models chosen for African stock market regulation may—through costs and pre-requisites—have created unnecessary barriers to listed equity finance for many African firms .

The *activist* recognizes that features of the typical African environment—such as sparse population, low incomes and poor infrastructure—make access to finance problematic. Indeed, the anonymous private financial sector has not been conspicuously successful in delivering finance for agriculture and the rural economy; for micro and small enterprises, for low income households; or long-term finance in general. This failure of the market will only be overcome by new entrants or re-engineered existing firms adopting a dedicated mission to be patient, take risks and experiment with new technology in the "fight for an inclusive financial system." In this respect, some recent African initiatives, including the use of new technology, are at the cutting edge.

Inadequate governance is the Achilles heel of many activist interventions, especially in countries whose overall governance structures are not yet strong. Activism in finance can only safely be entrusted to entities with strong governance. To get around this, it is worth exploiting cross-country/regional frameworks to strengthen governance (of development finance, banking, regulation). Greater regional integration of finance can also help overcome the problems of scale and lack of competition which increase the cost of financial services in small African economies. And some activism is counterproductive—such as imposing impracticably low interest rate ceilings in a misconceived attempt to protect borrowers.

Policy design here requires balance (**devoting attention to development needs while respecting "safety-first"**), attention to detail, and greater awareness of the priorities both among African policymakers and the wider financial community. If elites begin to see the possibility of participating in the benefits of sustained growth, then the cycle of short-termism might be broken. And, if they really engaged with the 'bottom of the pyramid' in Africa, **international financiers might find it more profitable** than they now expect.

Growing aid flows provide a signal opportunity for Africa and a challenge for its financial systems. **The real growth potential of these inflows will only be realized if domestic financial systems are able to intermediate them effectively**.

A preliminary look at the facts and an outline of the policy perspective which has guided the preparation of Making Finance Work for Africa – still to be finalized as this preview goes to print – is presented in the following pages.

Check the website http://www.worldbank.org/finance/discussion from September 2006 for the pre-publication draft and for information on how to receive a copy of the final version.

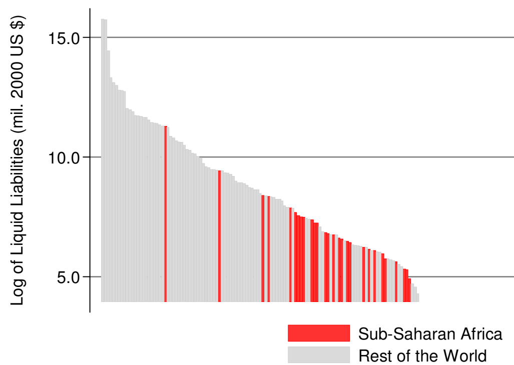
African Financial Systems: a Look at the Facts

Making Finance Work for Africa surveys the current state of African[1] financial systems in an international comparison. This preview summarizes some of the key findings. It begins with the banking system and mainstream nonbank finance, including securities markets and insurance, pension and collective savings institutions. It then looks at access for both households and enterprises.

Banking system

African banking systems are small – absolutely

Figure A: *Size of banking systems across countries*



African banking systems are among the smallest in the world (Figure A), a fact which militates against economies of scale and competition. To a large extent this is related to low incomes, given that there is a two way linkage between financial depth and national income growth. Deeper financial systems tend to boost subsequent growth; but the level of per capita income is also a major determinant of current financial depth.

Consistent with this relationship, financial intermediary development in most African countries is lower than in other regions of the world. This is true both for broad money (which is a measure of the resources mobilized by the banking system) (normalized by GDP in Figure B), and even more so for bank credit to the private sector (which is the better indicator of the growth potential of financial intermediation) (Figure C). Broad money averages a mere 31 per cent of GDP in Africa, compared to 54 per cent in East Asia and Pacific and 100 per cent in high-income

And relatively

Figure B: *Broad money holdings as % GDP across countries*

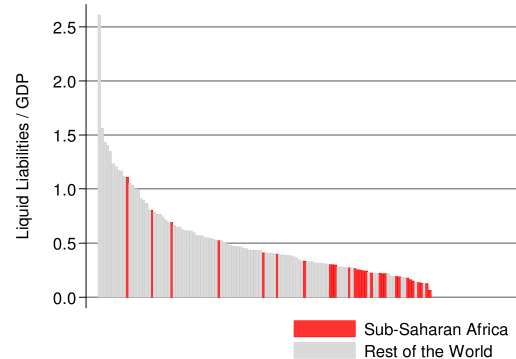
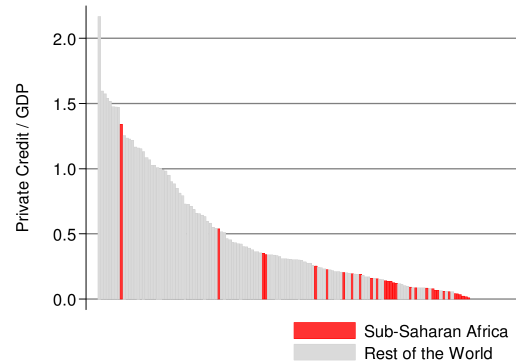


Figure C: *Private credit as % GDP across countries*



countries. Similarly, private credit averages only 18 per cent of GDP in Africa, compared to 27 per cent in South Asia and 109 per cent in high-income countries. Indeed, private credit averages 11 per cent of GDP in African low-income countries, but 21 per cent in other low-income countries.

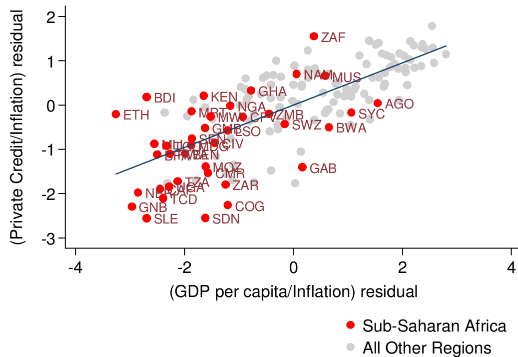
Within Africa also, the tendency for higher income countries to have deeper financial systems is observed. Consistent with its much higher mean income (and special economic structure) South Africa is a large outlier; two other outliers in the deposit data, Mauritius and the Seychelles, are offshore financial centers.

An additional important explanatory factor for financial depth is inflationary expectations. After taking account of both income and inflation, African banking depth is still below the average – though by a smaller amount (Figure D). Capital

[1] Throughout, "Africa" refers to Sub-Saharan Africa.

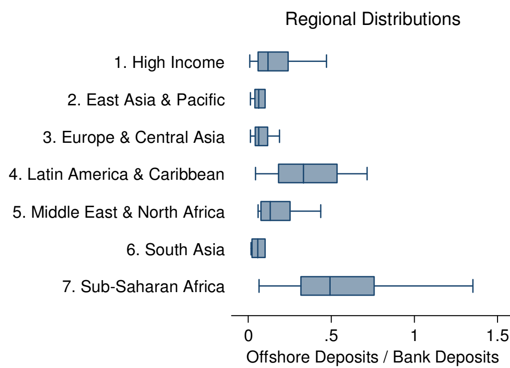
Even considering their income and inflation levels

Figure D: *Private credit to GDP vs. GDP per capita* (partial scatter plot)



One reason: offshore holdings

Figure E: *Off-shore to domestic bank deposits*



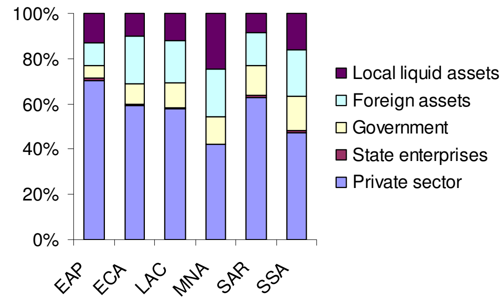
flight may also be a contributing factor: offshore holdings of bank deposits by Africans is higher than in other regions (Figure E).

Another striking characteristic of African banking is the low intermediation ratio: the median banking system in Africa allocates more of its resources to liquid assets and lending to government than in other regions, leaving a lower share of credit to the private sector (Figure F).

Though financial depth remains low, there are unmistakable and encouraging signs of a recovery. Since 1995, real private sector credit has been growing at an accelerating rate, and its median value has doubled in the past decade. Even as a share of GDP it has turned the corner, with the median share reaching almost 14 per cent in 2004, about a third higher than at its anemic trough in 1996. Four out every five African countries for which the data is available have seen

Banks remain liquid

Figure F: *Asset composition of banks across regions*

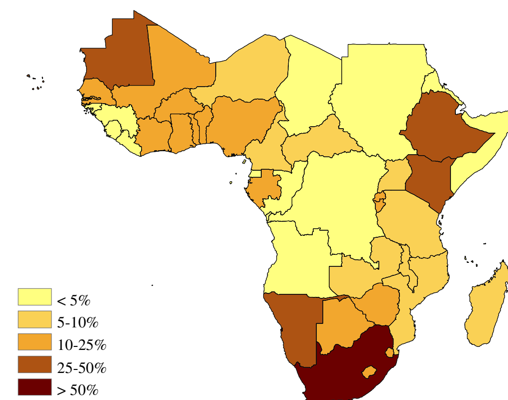


financial depth increasing since 2000. The continued wide variation in financial depth among African countries (see map) shows that the upside potential is considerable, especially in countries like DR Congo and Mozambique where private sector lending remains minuscule.

Africa's banking systems are characterized not only by low levels of intermediation but also by high interest rates and high intermediation spreads. Wholesale real interest rates increased significantly in the median African country in the early 1990s, partly a direct and intended consequence of interest rate and macroeconomic liberalization, as well as being influenced by fiscal and macroeconomic expectation effects.

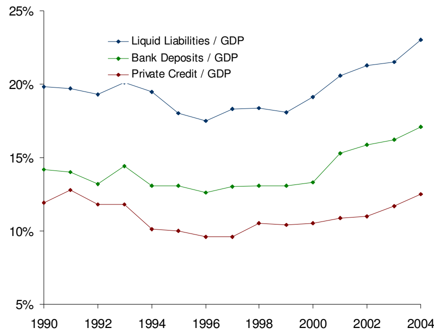
African banking systems tend to have higher interest spreads and intermediation margins than banks in many other parts of the world, although many Latin American and Eastern European countries have at least as high margins (Figure H). In interpreting these numbers it needs to be recalled that the gap between interest received and interest paid by the banks goes to pay for staff and other non-interest costs, to make provisions for loan losses, and to contribute to profits. Econometric analysis points to the small size of African banks, high inflation and

Sub-Saharan Africa: Private Credit / GDP (2000-2004 avgs.)



But there is a deepening in progress

Figure G: *Financial depth in Africa 1990-2004*



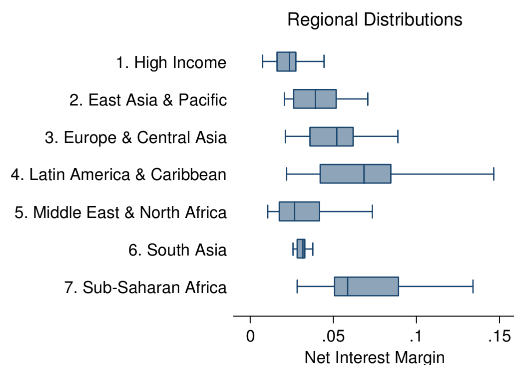
deficiencies in the contractual and informational frameworks as driving forces behind intermediation margins and operating costs.

However, lack of competition is also a factor. Overall profitability of African banks is high: the average African bank has profitability (return on total assets) of 2.1 percent, more than three times the profitability of non-African banks (0.6 percent). While in a world-wide sample of banks there is no significant difference in profitability across banks of different ownership structures, foreign-owned banks in Africa are more profitable than foreign-owned banks elsewhere (even controlling for the higher profitability of banking in Africa) and more profitable than locally-owned banks. This high profitability can be attributed both to high risk premiums demanded by bankers and to a lack of competition.

Following a wave of privatization and restructuring of banks, including state-owned banks, in numerous African countries the balance of ownership structures has shifted dramatically

Banking is expensive

Figure H: *Net interest margins across regions*



in recent years. Now the foreign banks are back in force. While somewhat parallel trends have occurred in other parts of the world, the process has gone further in Africa than in other regions. Two out of every five African banking systems are mainly foreign-owned, and only three countries (Ethiopia, Eritrea and Togo) are still dominated by state-owned banks (Figure I; also see map)

In part because they are so small in terms of total assets, most of Africa's banking systems are also highly concentrated. The three-bank concentration ratio, based on total assets, averages 73 per cent for the 22 African countries for which data is available, which compares with 60 per cent for the World as a whole. The lowest ratios are for the largest economies—South Africa and Nigeria. Apart from these, all other African countries have ratios of at least 59 per cent. The general picture is one of market dominance by a small number of banks. In Mozambique, the largest bank (a foreign-owned one) holds 48 per cent share in the lending market. In Mauritius, the largest two banks account for 77 per cent of the lending market.

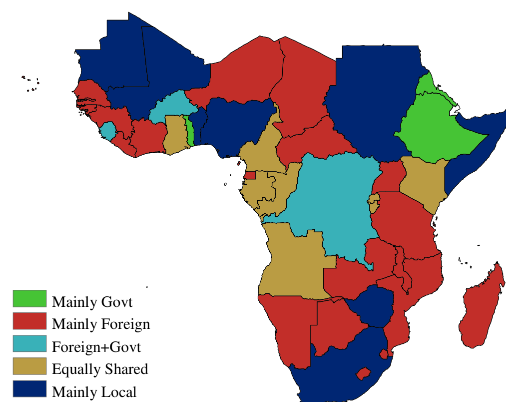
Nonbank finance

As in most low and lower-middle income countries, banking dominates African financial systems today, but this will change.

Securities markets

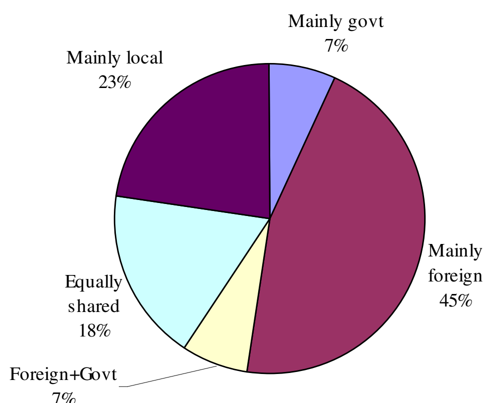
There are 15 organized securities markets in Africa, one of which – the BRVM headquartered in Abidjan – caters to the eight country UEMOA

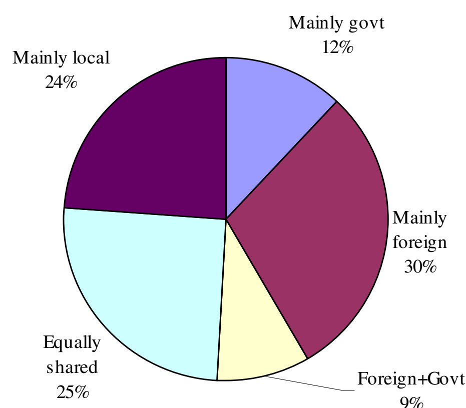
Sub-Saharan Africa: Predominant Form of Bank Ownership



Foreign banks are more present in African countries than in other regions

Figure I: *Patterns of bank ownership. Africa and the Rest of the World*





zone. The Nigerian, Zimbabwe and Johannesburg exchanges have the largest number of listed firms, but measured either by market capitalization or value traded (even as a percentage of GDP). Johannesburg is much larger and more active than the rest. Apart from Johannesburg, the market capitalization of the next seven exchanges is about 25 per cent of GDP, with some pick-up in the last couple of years (Figure J). All of these exchanges are rather inactive, with median value traded in recent years of about 1 per cent of GDP or less. Scale issues in equities have been mirrored in the bond market; only a limited number of private bonds have been listed. In Tanzania, equity market capitalization is 25 times that for corporate bonds. Ghana has three corporate bonds, compared to 30 listed companies.

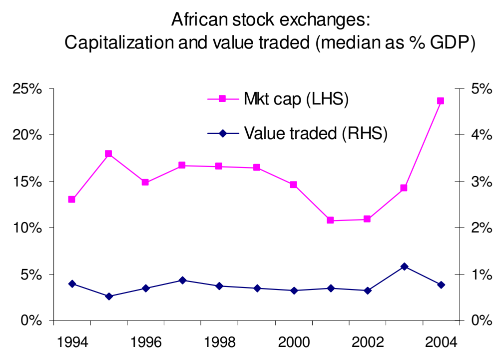
The small size and illiquidity of Africa's stock exchanges partly reflects low levels of economic activity, making it hard to reach a minimum efficient size or critical mass, as well as the state of company accounts and their reliability. Several of the exchanges were established in the late 1980s and 1990s to facilitate privatization processes and in the hope of attracting inward portfolio investment. To the extent that their establishment was driven by outside influences, rather than emerging from a realistic need felt in the market, whether by investors or issuers, it is perhaps unsurprising that many have so far struggled to reach an effective scale and activity level. This is reflected also in the very small amount of funds raised through new issues including IPOs and other public sales of equities.

Nevertheless, issuing activity has been picking-up. Ghana had five new equity issues in 2004, accounting for $60 million. The Kenya Electricity Generating Company KenGen IPO of 2006 – the first for five years in Kenya– attracted strong demand and enormous public interest. In Nigeria, the equivalent of almost USD 3 billion in new capital was raised on the exchange in 2003-5 in connection with the new capital requirements for banks.

Insurance, pension and collective savings institutions
Insurance penetration, as measured by premium income has not really taken off yet in most of

Stock exchanges are picking up

Figure J *African Stock Exchanges: Capitalization and Value Traded as % GDP*



Africa. With a few exceptions in Southern Africa (echoing the traditional, partly tax driven, success of UK life assurance), most countries have penetration ratios of less than one percent of GDP. Some countries have introduced a funded national social security system and funded pension funds for public servants. Where these exist, they are in an accumulation phase. While the actuarial valuations of several of these schemes raise questions about their long-run sustainability in the absence of parametric change, for the medium term they will be increasingly important suppliers of investable funds. To date, however, most insurance companies and pension funds have invested mainly into real estate, government securities and bank deposits and comparatively little in equities or corporate bonds.

Access for households and enterprises

Including the poor

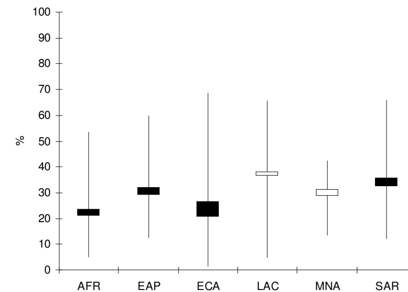
Long excluded from the formal financial system, the financial service needs of lower income households in Africa have begun to receive more attention from governments, NGOs, and increasingly even from banks. The accelerating expansion of formal and semi-formal microfinance and the political changes in South Africa have been major factors in this change.

There has been a steady growth of microfinance, and post offices in some countries continue to provide savings media to small savers.

Yet, at most, only one in five of African households have any access to formal finance. While this is lower than in other regions, the gap is, perhaps, smaller in this dimension than for other aspects of finance. (Figure K). (In addition, of course, most households are involved in informal finance groups.) Precise data is not yet available except for a handful of countries, but piecing together what information is available allows a rough approximation of this percentage for each African country. Mapping the resulting figures shows how widely varying access is (see map). In addition to relatively high percentages in Botswana, Mauritius and South Africa, the estimated access percentages are *relatively* high in Angola, Benin, Gabon and Niger, as well as Zimbabwe.

Access for households varies but is on average lower than in other regions

Figure K: *Percentage of Adults with an Account, Regional Extremes, Medians and Means*



An in-depth picture of financial access can be obtained by survey methods, and a new wave of household surveys focusing on finance in Africa is under way. The Finmark surveys in Southern Africa have already highlighted the importance for low-income individuals of such barriers as documentation requirements to open a bank account. These requirements, which have been reinforced in many countries recently as a part of the effort to counter money laundering and the financing of terrorism, can create artificial barriers to financial access for a large section of the community.

To an extent, low access percentages reflect general economic conditions. Per capita income alone can explain a high fraction of the variation in access across countries – and, although African access figures remain about 2 percentage points lower on average after taking account of income, this figure is not statistically significant. Remoteness from bank branches, ATMs and even Point of Sale (PoS) outlets also militate against access of low income groups to banking.

Affordability and convenience are important barriers to the ability of the poor to use banks. Most commercial banks have traditionally taken the view that low or uncertain income means an unprofitable customer. Minimum deposit balances are often set by banks at levels that are unattainable by the poor -- as high as 50 per cent of average per capita GDP in some countries.

At the other end of the market from banks, a diverse collection of financial mechanisms is used by the poor. When all types, formal or informal, are taken into consideration, it is sometimes

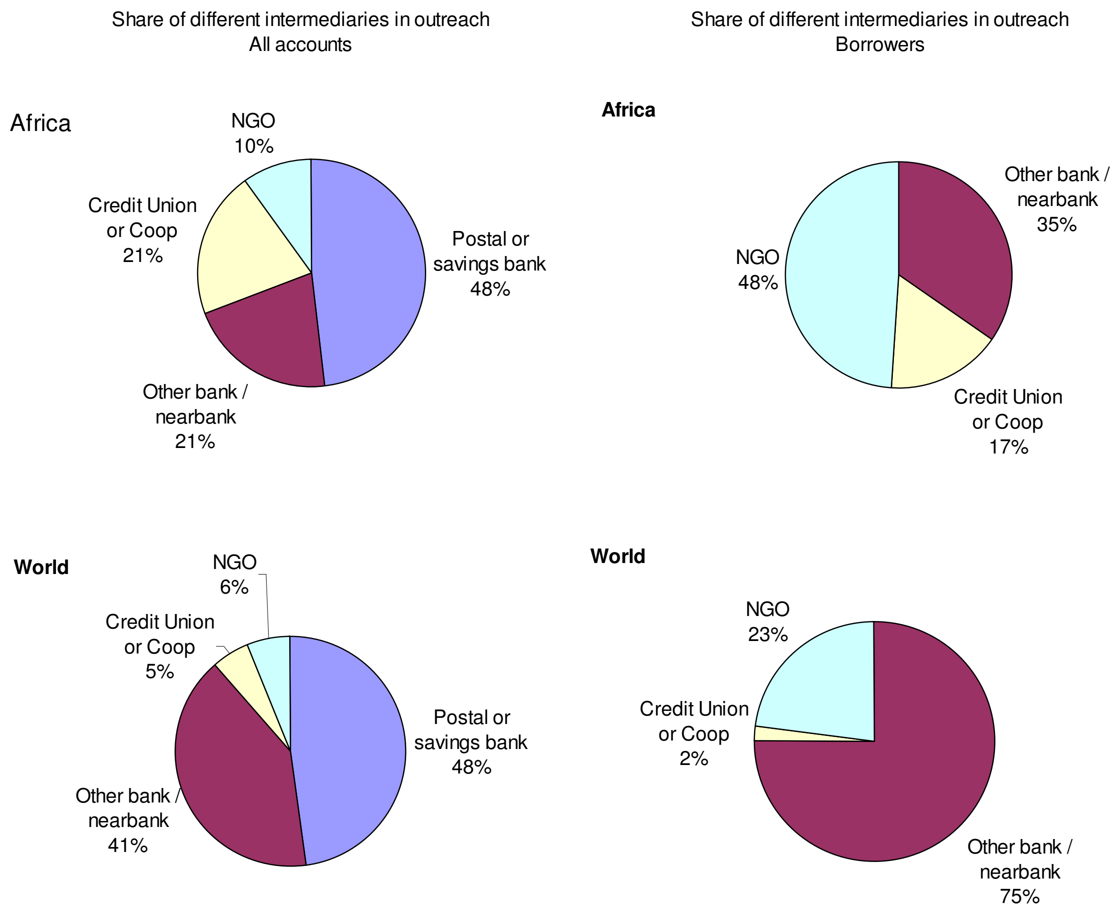
estimated that 80 per cent of the population have dealings with one or other form of financial intermediary even if it is just an informal money-collector or suitcase banker. Focusing on the formal, one of the most striking features of the recent and ongoing expansion of the microfinance movement in Africa is the proliferation of different types, both in terms of financial technology employed, organizational structure, degree of formality and regulation and clientele. The diversity seems wider than in other regions. Not only that, but the relative importance of different models—even of formal microfinance—differs widely from country to country.

However, big providers are dominant in formal provision. The 44 largest entities (by outreach) account for about 80 per cent of the client base across Africa. Each of these entities caters for at least 100,000 clients. As with the full list, the top 44 includes a wide range of different types of entity: state-owned banks, including postal savings banks, privately owned banks, cooperative savings and credit institutions, and NGOs. The different types assume different relative importance in different countries.

Overall, almost half of the accounts recorded are at savings or postal banks. This is about the same as reported for the developing world as a whole. (It should be noted, though, that inactive or dormant accounts can be very prevalent in postal savings banks). But the breakdown of the other half is quite different in Africa, where various forms of credit cooperatives and NGOs both account for a much higher percentage (20 per cent and 10 percent respectively) than in the rest of the world (Figure L) . However, these shares vary sharply across Africa. In 11 of 42 African countries in the database, savings and postal

Different types of institutions contribute to household access

Figure L: *Share of Cooperatives, NGOs, Savings and other banks in providing access*



"More African enterprises report access to and cost of finance as a major constraint to operation and growth of their firms than do entrepreneurs in other regions of the world."

banks report more than three-quarters of the accounts; non-bank MFIs have more than three-quarters in 16 countries. This displays the contrasting mix of organizational forms that are observed in African countries.

The range of services available differs as between different types of intermediary, with many savings banks offering no credit and many NGO microcredit institutions offering only limited savings vehicles.

Other onshore household financial services are generally scarce, even for middle-income customers. In particular, mortgage finance is hard to come by—the stock amounts to less than 2 per cent of GDP in all but a handful of countries.

Enterprises

If there is a single survey statistic which justifies an African development focus on finance it is the finding in investment climate surveys that more African enterprises report access to and cost of finance as a major constraint to operation and growth of their firms than do entrepreneurs in other regions of the world (Figure M).

The financing patterns of firms in Africa show some similarities—but also some striking differences—to those of firms in other regions. African firms finance about 68 per cent of their investment needs with internal funds, more than firms in Latin America and Asia but less than firms in the Middle East and North Africa and Eastern Europe and Central Asia. Firms in Africa finance a smaller share of investment with bank credit than firms in East Asia and Latin America, but a larger share than firms in Middle East, Europe and Central Asia and South Asia. However, firms in Africa finance less investment with equity finance than firms in any other region – most likely reflecting the underdevelopment of capital markets – and finance less investment with trade finance than firms in any other region, which might reflect low levels of trust. Numerous studies have shown domestic trade credit is mostly limited to networks within ethnic communities. While such limited trade credit thus helps entrepreneurs that form part of these networks, by the same token, they exclude entrepreneurs that are not part of the network.

Beyond the observation that smaller firms have less access to financial services, many observers of firm finance in Africa have commented on the phenomenon of a missing middle in credit provision. Medium and large firms are catered to by formal financial institutions, while micro-firms have often access to MFIs. But in between these categories, small firms, often growing micro-firms, have difficulty finding the funds to expand. MFIs may not be able to meet their borrowing needs (because of lack of funds, regulatory limits on maximum loan amounts, or a self-imposed limitation on client size). At the same, banks and finance companies do not consider these firms formal enough to extend credit to them. Collateral and documentation requirements are often at the center of the reluctance of banks to extend loans to these segments of the firm population.

The Policy Context

Building and preserving an enabling environment for domestic finance to flourish is a goal on which all will agree. But how can it be delivered…and is it enough?

African policy reforms to date have gone some distance towards stabilizing the macro-economy and removing incoherent administrative controls on wholesale interest rates. Insolvent banks have been intervened: many of them have been recapitalized and placed under better management and ownership. Much else has been done, for example to improve the regulatory framework for banking.

Clearly more is needed, but what? There can be no dispute about the importance of macroeconomic stability, contractual certainty and policy and commercial transparency as the foundations of an effective financial system. But that is not to say that these foundations are securely in place throughout the continent. Far from it. Reforming the legal and judicial system and improving information and transparency are tasks which are far from complete. Macroeconomic instability, though much less prevalent than it was, is still a threat in certain parts; crowding out by government borrowing has been evident in several countries; and the risk of major policy reversals is factored into investor decisions.

Certain building blocks, including rationalization and clarification of laws, streamlining of court procedures, establishment of credit registries, training of financial professionals, are well-accepted as key components in moving towards more effective financial systems. *Making Finance Work for Africa* does not dwell on these widely agreed goals and building blocks—which are not Africa-specific. Instead, the focus is on matters which are not so clear but which speak more specifically to Africa's distinctive needs. The report asks what policy response can help guarantee that modern technology, organizational innovation and internationalization are exploited to the maximum towards that goal.

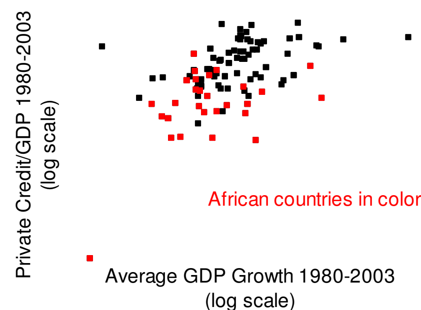
Financial systems in the fight against poverty

African formal economies are small, and even then are relatively light users of financial services, as is reflected in the shallowness and limited outreach of finance. A more effective financial system would not only intermediate on a much larger scale, but in doing so would help improve enterprise productivity and growth. This would occur not least in sectors that have the potential to contribute directly or indirectly to exports, especially of nontraditional goods and services. Faster national economic growth is the only sure way to a sizable and sustained reduction and eventual elimination of absolute poverty. In addition, though, improved access to financial services for poor people and in rural areas would also directly help improve their circumstances and help reverse what has, at least until recently, been a trend in the continent toward widening inequality and increasing poverty rates.

Emphasizing finance as a driver of growth and poverty reduction is supported by cross-country evidence on its effectiveness on both counts. Indeed, careful comparative analysis of the growth rates of different countries over a thirty year period has produced convincing evidence that having a deeper financial system contributes to growth (and is not merely a reflection of prosperity) (Figure N). Countries with deep financial systems also seem to have a lower incidence of poverty than others at the same level of national income. Data also shows that individual firm growth also responds to access to credit and to the conditions that favor such access.

Deeper financial systems are causally associated with faster growth—worldwide and in Africa

Figure N: *GDP growth rates and financial depth*



Without a well-functioning financial sector to allocate and reallocate investable resources, African societies risk stagnating inasmuch as investment and strategic decisions are taken by a relatively closed group of incumbents (public or private), because only they have the resources to implement large scale plans. By allocating and re-allocating resources on a more objective basis of creditworthiness and prospective returns, a finance-rich economy should also be more conducive to a wider distribution of economic power and influence, which in turn should feed back onto improved national economic performance on many dimensions.

Furthermore, financial development can help form a broader elite as wealthy and middle-class people can acquire a share in the success of local economic ventures and begin to define their own prosperity in terms of national prosperity. One concrete example is the way in which local elites have become interested in the fortunes of recently privatized firms which, though often majority-owned by foreigners, have a fraction of their ownership listed on local exchanges – perhaps one of the most significant effects of these exchanges so far. If elites are invested in national economic prosperity (rather than defensively attempting to secure – for a time – their share of a static or declining pie that may at any time be swept away by social or economic crisis), they may work harder to introduce policies that underpin economic growth.

Improved services

African financial sector policy should thus have two prongs: growth and access. Within these, the most pressing needs in African finance are (i) to increase the availability and lower the cost of credit to productive enterprises and (ii) to extend the reach of basic savings, payments, credit and insurance services for low income people and for the smallholder farms and micro enterprises which provide their livelihood. Africa also needs a wider range of longer term facilities (including mortgage finance); greater possibilities for risk management and diversification, including more transparent price discovery, and improved marketability of tradable securities including debt and corporate equity. Each of these areas will make demands on scarce technical and managerial skills, including prudential management, regulation and supervision.

The strength and limitations of both modernism and activism

Putting in place the infrastructures necessary for effective financial sector functioning will require a protracted period of *modernization*. Governments have a central role here in creating the enabling environment. Yet the modernist agenda must not over-reach itself through mindless transplantation of overambitious structures from the advanced economies. And while modernization is maturing, policymakers also need to be actively engaged in encouraging the numerous initiatives already being taken by financial market participants to reach a wider market. Effective governments will have learnt the lessons of the past and, in order to avoid counterproductive interventions resulting from weak governance, will strive to create favorable background conditions for development-oriented finance, but will not themselves take the lead in implementing an *activist* agenda. To fill this gap, the potential for regional entities, and partnerships with local and international NGOs and the private sector needs to be explored actively and in a focused manner. Donors too can have a potentially valuable role as *disinterested* activists in bolstering specific initiatives.

Coping with a difficult environment

While African countries are spread across a spectrum of financial sector performance, there are sufficient similarities between the underlying economic conditions which face financial firms in most of the countries to allow for several generalizations. In addition to low savings rates, finance in most African countries works within an environment which is extreme in four key dimensions: scale, informality, governance and shocks.

- *Scale* refers to the small size of the economies, and even more of the national financial systems, the financial firms and their customers. Sparse population resulting in isolation and great distances (at least in terms of travel time) to points of services is another aspect.

- *Informality* refers not just to the status of client enterprises of financial intermediaries but of the markets within which they work; informality reduces the degree to which reliance can be placed on systematic documentation, adherence to a predictable schedule, or even a fixed place of business.

- *Governance* problems arise at the level of private and public institutions, but are probably relatively more severe in the public sector. This reduces the credibility and stability of government policy and increases the danger that policy goals will be subverted in implementation.

- Not all types of *shocks* are more severe or more frequent in Africa, but the continent's history over the past half-century has been marked by a high incidence of occasional economic or political meltdowns, on the frequency of up to one per decade per country. At the micro or 'idiosyncratic' level, risk is also very high for individual households near or below the poverty line, and for small farms and firms.

While similar difficulties are also found elsewhere, the frequency with which this quartet of environmental obstacles are all met together in Africa means that there is a distinctive flavor to policy analysis in the region.

In order that financial services can be delivered safely and at reasonable cost despite these difficult conditions, stakeholders need to find solutions drawing on innovations in financial, information and communications technology, internationalization and on well-adapted organizational structures.

"Finance in most African countries works within an environment which is extreme in four key dimensions: scale, informality, governance and shocks."

There is movement

There are stirrings of change in African finance, some of them vigorous. Many countries have adopted extensive policy reforms, with the result that severe financial repression and moribund state-owned banks no longer dominate the scene. A new wave of intermediaries, many of them market-based, have begun to adopt new approaches that promise to address the challenges. Cellphone technology is being used for retail payments and for price transparency, and modern technology also underlies the surge of retail lending in several African countries. The rapid expansion of MFIs, with varied approaches to employing social capital, and the growing links between MFIs and mainstream banks illustrate the adaptation of organizational structures to local conditions. And the re-entry of foreign-owned banks represents only one aspect of a growing potential in internationalization and regionalization.

Finance and social change

But there is more. If it is correct to see the low level of private sector investment as both a cause of Africa's growth shortfall, and a consequence of low confidence engendered by the repeated setbacks in most countries in the region, it becomes evident that escape from these conditions can hardly be imagined without a central role for finance. Policies that strengthen finance will also address these core development gaps; they can also generate a lock-in effect that raises the commitment of national elites to growth-oriented policies.

Finance for Long-term Growth: Enriching the Flow of Finance to Transform the Economy

This part of the *Making Finance Work for Africa* deals with the functioning of mainstream financial institutions as mobilizers of funds, providers of risk management services, and financiers of medium and large-scale enterprises and government. It is here that finance makes its major contribution to sustained economic growth and stability.

Banks are and will remain at the heart of African financial systems. Their effectiveness could be greatly improved if there were stronger underlying infrastructures, including in the information and especially legal dimensions. They can function without, for example, a robust regime of land ownership rights and without predictable judiciary, but they do so in a manner that is greatly constrained. Absence of these infrastructures reduces bank lending.

Indeed, the high, and increasing, liquidity of the typical African bank points clearly to the difficulty they have in lending mobilized resources. It is not that too much is mobilized – indeed, high liquidity ratios are most evident in countries where bank deposits represent a low share of GDP. And, although there are several instances where one can point to inappropriate and unnecessarily constraining regulations, it is clear that the main obstacles to on-lending lie in the difficulty banks have in finding bankable projects, given the information and contractual infrastructures, and their traditional loan underwriting strategies. Improving these infrastructures is on the agenda in nearly every African country; but it may be a long haul and will certainly require political follow-through.

There have been extensive ownership changes in African banking, following the bankruptcy of many state-owned banks. International banks have returned in force: new entrants from South Africa, returning ex-colonial banks from Britain and France, as well as a handful of South-South linkages especially from the Gulf and South Asia. A new wave of regional banks within Africa is also flourishing. Foreign banks can bring their established technologies, management skills and deep pockets to the host countries. Nevertheless, there is some understandable anxiety that below-prime customers might not benefit so much or that foreign banks will display less commitment to the host country. Global experience does not feed such anxieties, though. International experience suggests that, even if some of the foreign banks concentrate on the top tier of customers, the system as a whole tends to adapt in a way that benefits customers generally. Indeed, even greater openness to regional and cross-border banking could help overcome the dual problem of insufficient scale and lack of competition in finance.

Yet the influence of the state on financial markets lingers more than is immediately evident (direct government ownership being supplemented by parastatal shareholdings). Lip service to the concept of privatization can leave a bank even more vulnerable to the weaknesses that are often associated with state ownership. And political pressures on lending decisions of banks – both state-owned and private – continue to be a problem in some countries.

The lack of long-term finance is partly a reflection of the long-term risks already mentioned, partly an endogenous response to the need for monitoring and, where necessary, recontracting. In some countries it is worsened by to a regulatory-induced bias restricting maturity transformation.

The government-owned and operated DFI is not the most promising source of long-term resources. Recurrent political interest in state-controlled DFIs is unlikely to lead to results any more successful than the last wave of such institutions, essentially because of governance problems.

"The main obstacles to on-lending lie in the difficulty banks have in finding bankable projects, given the information and contractual infrastructures, and their traditional loan underwriting strategies."

Instead, the long-term funds that have already been accumulated – and continue to accumulate – in pension and social security funds can be better used. Given the right governance structures, and complemented by a more energetic approach to investment banking by the leading intermediaries, they could be the key to an expansion of both long-term and risk capital. Good allocation of long-term funds will benefit from effective securities markets to help transparent pricing.

For the present, most organized African securities markets are largely primary markets with relatively little secondary activity. Perhaps an over-elaborate model of regulation has been adopted for these markets (the modernist model over-reaching itself), effectively precluding small issuers, yet failing to achieve substantial liquidity for larger issuers. Could the smaller firms in the smaller locations be better-served by lighter governance—something like a 'second-board' approach, with greater emphasis on an over-the-counter type of funding? The larger firms could benefit from listing or cross-listing on larger exchanges.

Housing and infrastructure are sectors which demand longer terms funds but with specific and typically more limited risks: the prospects for financing each are reviewed. These could benefit from an upgrading and expansion of investment banking skills.

With the failure of several state-owned insurance companies, and the entry of regional or international firms to provide the basic insurance products, general insurance is gradually making a come-back in Africa. But the potential complexity of insurance business makes it essentially a business in which it is the buyer that must beware. Most national regulators are ill-equipped to assess and discipline fraudulent or reckless insurers. This could be a case for regional cooperation in supervision—potentially as an annex to a regional approach to banking supervision.

Regional cooperation and integration has long seemed to offer a possible solution to problems of small scale. There are numerous dimensions in which regional integration could be further pursued. Currency unions are firmly on the political agenda (here there are three working examples— though in this case they are just the survivors of a more numerous set of colonial relationships). Despite political commitment to single currency programs (undoubtedly inspired by the EMU project), most practitioners do not expect further single currencies to become a reality in any short time-scale, especially given the diversity of national macroeconomic policy conditions and the inability of most African governments to provide a fully credible commitment to a single currency). It might be more fruitful to redirect political will in the short-run to cooperation on bank and other intermediary supervision, and to exploiting regional gains from stock market linkages.

Aggregate national resource mobilization is primarily a matter of convincing the wealthy that they can safely leave their deposits in the local banks. That means macro and political stability, sound banks, adequate competition and a quasi-tax regime that allows reasonable rates of interest to be paid. Absence of these conditions helps to explain why African savings rates have been low.

It will be important to ensure that monetary and fiscal policy are carefully adapted to fluctuations in external flows if the promised increase in aid flows (as well as the effects of the oil price boom in producing countries). Demand for money is likely to grow in line with the improved prospects created by these inflows, thereby allowing greater financial deepening provided this is not choked-off by unduly restrictive credit policies. For the financial sector, the challenge will be to find ways of intermediating these funds effectively, so that they are absorbed by the urban and rural economies in such a way as to generate the maximum growth dividend.

Finance for All -- Reaching Difficult Markets

The challenge of Increasing access for households and micro, small and medium sized enterprises to formal financial services must be a key priority for all concerned with African development. To be sure, many Africans have recourse to informal finance for both household and enterprise needs. Indeed, the richness and persistent centrality of informal financial networks for most Africans is a phenomenon that has long fascinated observers. It is not to diminish the current importance of these networks to confine the present discussion to the formal financial sector. It is the formal sector that is the main target of policy and it will surely become increasingly important in serving the majority of African households and firms.

Access to formal financial services is an area in which considerable progress can be envisaged in the years ahead. New technology, both in terms of financial engineering and information and communications technology, can be brought to bear. Some of these innovations are particularly appropriate for overcoming the barriers facing African finance. This section of *Making Finance Work for Africa* reviews some of these technologies, showing just how they can contribute and, by using real, albeit in some cases experimental, African examples, illustrating that they can be made to work in Africa.

These innovations include both applications of information and communications technology, benefiting from the increasingly wide coverage of cellphone networks. They also build on insurance and credit management techniques carefully adapted to African urban and rural conditions. Payments (domestic and international) and savings innovations are also exemplified. Some of the financial technologies discussed are not really new, even in Africa, but have not been employed as extensively as they could be.

The microfinance revolution has given MFIs the confidence to provide deposit and lending services to poor people. While various methodologies are employed by different MFIs and each claims special advantages for its techniques, it is clear that, given the will and management skills, this sector can reach out to low-income strata of the population in much of Africa, sometimes even without any subsidy, although the high interest rates that are often involved limit borrowing to high-yielding uses of capital. The challenge is to achieve scale and reach remote areas without losing management control of costs and of loan appraisal quality.

But it's not just to the needs of the very poor to which this chapter is addressed. With such huge swathes of the economy excluded in practice from access to financial services, attention needs to be paid to what in more advanced financial systems would be described as the middle-market. Small or even medium-sized firms may, given the state of many African economies, be on the margins of informality, and are not now in a position to maintain proper business accounts. These are poorly catered-for by banks whose procedures presume a greater degree of formality. Farmers above the subsistence level are often in the same situation. Techniques such as leasing can help here, and over time improved credit information, including an upgrading of enterprise accounting (assisted by extension and business advisory services) will yield benefits. From the other side, though, greater effort of the part of intermediaries to adapt relationship lending to local conditions could also be beneficial.

Who will deliver these enhanced services? A proliferation of formal and semi-formal intermediaries – more than a thousand across Africa – are currently engaged in microfinance of one form or another. They vary enormously in scale, sophistication and organizational design. Some have just a few dozen customers; others, especially government-owned savings banks, have more than a million. Some merely provide short-term loans based on foreign donations, others are full-service banks offering a range of depository and payments services as well as lending and other risk management. Some are cooperatives, or networks of cooperatives; some are for-profit; some are government-owned; some are owned or controlled by NGOs.

Advocates of mutuality sometimes argue that cooperatives should take the lead in delivering

finance for all. This view has been implicit in the legislative framework in effect in the UEMOA countries of West Africa. Others argue that the economies of scale and scope of multi-service banks will ultimately give them an unbeatable cost advantage in catering to the majority. The fact that intermediaries representing a wide variety of different organizational models have been successful in Africa argues against any dogmatic view either way on this point. Diversity and experimentation in organizational structure and business strategies at present seems to offer the best prospect for broader outreach. What is needed above all, though, is improved management and cost-control, as well as a greater awareness of the business opportunities by commercial financiers who have hitherto neglected the "bottom of the pyramid."

"The key to access is innovative financial engineering and technology, combined with ruthless attention to low cost."

Good management is essential. Not all of these intermediaries have been well-run. As elsewhere in the World, there have been failures among microfinance intermediaries. One response is an upgrading of supervisory capacity. But, bearing in mind the risks of over-regulation and the practical limits to supervising a large number of small intermediaries in a cost-effective way, autonomous improvements in intermediary management offer a complementary and potentially more constructive way forward.

The wider financial policy environment also needs to be conducive to expansion of microfinance. Ensuring sufficient competition to act as a spur to intermediaries finding ways of safely serving a wider clientele – and ensuring that unnecessary regulations do not prevent such efforts – is a key requirement. Among the most important regulatory issues in this context are interest rate ceilings. High lending interest rates remain a source of political sensitivity in many parts of Africa. Interest ceilings have been raised, but in many countries have not been removed, and the idea of a reimposition or tightening of ceilings turns up regularly. It is clear that microcredit cannot be extended on a commercial basis without charging high interest rates. Low interest rate ceilings are an insuperable barrier to widespread expansion of access to credit. Abuses of predatory lending are better tackled through policies of transparency and codes of practice for lending. At the same time, lenders cannot be complacent about costs that prevent them from reaching a wider market through lower interest rates. In addition, the higher the interest rates, the greater the threat of a political backlash that would impose damagingly low ceilings.

The key to ensuring access for smallholders and the poor is use of innovative financial engineering and modern technology, combined with ruthless attention to low cost. While some of this can be profitable, it is likely for the foreseeable future that at least some of the necessary energy and enthusiasm will have to come from the activism of public-spirited people whose job satisfaction comes from the social value of what they do rather than assurance that they are earning their opportunity wage in the global financial market. The modernist model alone will not be enough.

This discussion of "Finance for All" in *Making Finance Work for Africa* concludes by considering the contrasting role of the different players in facilitating microfinance. The role of government in providing a regulatory regime that adequately protects the depositors and guards against abuses of the financial system's integrity (through money laundering or terrorism financing) while not choking-off the capacity of MFIs to deliver services to the community is reviewed. A concluding suggestion is that donors can help strengthen managements and provide a possible supplementary source of good governance.

Making Finance Work for Africa will appear in November, 2006.
For the pre-publication draft and to find out how to receive a copy of the final version go to http://www.worldbank.org/finance/discussion.

For more on the World Bank's Africa work see http://www.worldbank.org/africa; for more on the World Bank's Financial Sector work see http://www.worldbank.org/finance and for financial sector research see http://econ.worldbank.org/programs/finance.