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IMPLEMENTATION OF THE UNITED NATIONS NEW AGENDA FOR THE DEVELOPMENT OF AFRICA IN THE 1990s

Towards advancing financial intermediation in Africa

Report of the Secretary-General

EXECUTIVE SUMMARY

This report reviews the present state of financial systems and practices, including informal and semi-formal traditional systems and practices, in Africa. It categorizes the countries under three broad stages of intermediation, primary, intermediate and advanced, and propose a course of future action, including support measures the international community could provide to enable African countries to move towards a more advanced stage of intermediation. It identifies the necessary preconditions for attaining each of the three stages and suggests, within the framework of existing African market-oriented reforms programmes, how those preconditions could be satisfied.

A number of African countries have undertaken financial sector reforms, generally in the context of stabilization and structural adjustment programmes. As a result, financial systems in several African countries have been stabilized and some of them have recorded visible progress towards enhancing financial intermediation and the efficiency of the financial systems. The region's performance in both the financial and real sectors has improved substantially, as evidenced by higher rates of gross domestic product (GDP), savings and investments and lower levels of inflation. Despite this progress, however, financial systems are among the weakest sectors in these countries and remain at primary or intermediate stages of intermediation. Thus, of the 41 countries, nearly 20 are still at the primary stage, 19 at the intermediate stage and only 2 may be said to be at the advanced stage.

There are several constraints that still confront African financial systems. First, the financial reforms in Africa so far have focused almost exclusively on the formal financial sector and neglected the informal sector, which has a vast saving potential awaiting mobilization, besides having a capacity to finance micro-enterprises in an effective and efficient manner. Second, central banks in Africa have limited operational independence and inadequate capacity to formulate and implement monetary policy. Third, the restructuring and rehabilitation of banks and non-banks are still incomplete, and management deficiencies are awaiting solutions. Finally, real sector restructuring, such as privatization and improvement of the financial performance of the public, and even some private sector, enterprises is yet to be addressed on a scale necessary to prevent the financial sectors in African countries from lapsing into recurrent financial distress.

Sustainable progress in advancing financial intermediation and its continued effectiveness require certain preconditions to be met. The foremost among these is the restoration and maintenance of a reasonable degree of macroeconomic stability. Among other preconditions are the development of human capital and management systems critical to the effective functioning of financial institutions, the building of expertise in maintaining an appropriate portfolio of financial assets, and the establishment of information channels. The process of complying with these preconditions is time-consuming and will achieve results only gradually. However, measures to advance financial intermediation should not be delayed but rather synchronized with efforts towards establishing these preconditions.

Efforts to promote financial intermediation in Africa should encompass both the informal and formal systems and the interlinkages between them. The main thrust of the policy recommendations as regards the informal sector is on harnessing to the maximum extent possible, and in a cost-effective manner, the savings and credit potential of the system; strengthening its ability to mobilize small savings from relatively marginal sections of populations; and encouraging decentralized lending that is, in areas largely untouched by the formal financial systems. The report then suggests a three-pronged strategy to develop the formal financial sector: fostering and strengthening various bank and non-bank financial institutions, devising and promoting the development of a variety of financial paper, and introducing and implementing indirect instruments of monetary policy. Of these, the first is perhaps the most important. Confidence in the financial system can be advanced by a comprehensive, well-designed and effectively implemented framework of prudential controls and bank supervision. Prudential norms guide financial institutions to manage their portfolios in a judicious manner, while bank supervision ensures prompt and regular follow-up action by the financial institutions if some weaknesses or loopholes are located by the supervisors. All this, in combination with a commensurate licensing policy with sanctions to enforce penalties, goes a long way towards strengthening the security and safety of the financial system.

The proposed strategy takes into account the financial reforms already undertaken by African Governments but suggests further that such measures be more comprehensive, addressing simultaneously the issues in three areas of institutions, assets and instruments designed to serve the requirements of each stage of intermediation and that the needed preconditions for their sustainability are put in place, depending upon the stages of intermediation reached. Detailed recommendations stemming from this strategy are contained in section VI of the present report.

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I. INTRODUCTION

1. The present report has been prepared in response to General Assembly resolution 48/214 of 23 December 1993 on the United Nations New Agenda for the Development of Africa in the 1990s, in which the Secretary-General was requested to undertake a study, in consultation with relevant financial institutions, on financial intermediation systems and practices in African countries, to be submitted to the Assembly at its fiftieth session with recommendations for appropriate measures. The above resolution was adopted in the light of the statement made by the Tokyo International Conference on African Development, held in October 1993, that "further improvements in financial systems and practices are needed to stimulate domestic savings investment and to prevent and reverse capital flight". It further noted that Africa's development partners pledged to "continue to provide assistance in order to improve the enabling environment which requires ... the development of financial intermediation".

2. The objective of this undertaking was to draw policy recommendations from an in-depth review of the existing financial systems in African countries, including the current traditional systems and practices of capital formation at the local level, with a view to improving financial systems in those countries through the adoption of practical and realistic measures focused specifically on development of the private sector. These recommendations should include policy, financial and technical measures to promote intermediation, and the required support measures that the international community could provide.

3. The Office of the Special Coordinator for Africa and Least Developed Countries was entrusted to undertake the study and a study team consisting of international and African resident consultants was engaged to carry out the task. The reviews of financial systems aimed at identifying the factors - economic, legal, institutional and regulatory - affecting the development of a financial system. In this context, the study reviewed recent efforts at financial reforms undertaken by African countries. The financial system is broadly defined as comprising various informal, semi-formal and formal institutions, including commercial banks and development finance and savings institutions such as post offices, insurance companies, pension funds and discount houses.

4. The report is prepared on the basis of the findings of the study team and incorporates the comments made by major financial and international institutions, including the United Nations Development Programme, Economic Commission for Africa, International Labour Organization, Food and Agriculture Organization of the United Nations, the World Bank, International Monetary Fund, International Fund for Agricultural Development, African Development Bank and Organization of African Unity.

5. A set of recommendations is proposed for consideration by the General Assembly, including policy and operational measures to develop financial intermediation specifically to stimulate the development of the private sector through the mobilization and channelling of savings.

II. THE CONCEPT OF FINANCIAL INTERMEDIATION

A. Introduction

6. The financial sector in Africa is characterized by a low level of intermediation and a narrow range of both financial institutions and instruments. The system is split between formal and informal sets of intermediaries, each commanding significant amounts of resources but having only a few linkages between them. The formal financial system in Africa has faced a number of internal and external constraints, including inadequate technical and managerial capacity, antiquated legal and regulatory frameworks, inappropriate macroeconomic policies and pronounced government intervention, that not only hampered its growth but actually caused significant disintermediation in a number of countries. There is general recognition that such a system has resulted in deficiencies in savings mobilization and their allocation, and in lack of appropriate finance, especially microfinance. It has also constrained the ability of monetary authorities to conduct an efficient monetary policy.

7. In recent years, a number of African countries have undertaken financial reforms, established institutions and introduced instruments to advance financial intermediation. However, the financial systems in Africa still have a long way to go to meet the objectives that are generally served by financial intermediation, and to adapt themselves to the peculiar circumstances and meet the needs of Africa.

8. The present report aims at reviewing the state of financial systems and practices in Africa, categorizing countries under three broad stages of intermediation, primary, intermediate, and advanced, and proposes a course of future action, including support measures the international community could provide, to enable African countries to move towards higher stages of intermediation. It identifies the necessary preconditions for the attainment of each of the three stages of intermediation and suggests how those preconditions could be satisfied. As a starting-point, the report accepts the present thrust of most of the African reform programmes, which are market-oriented and aim at an incentive framework within an environment of macroeconomic stability.

B. Definition

9. Financial intermediation is the activity that involves raising funds from savers and placing them with borrowers. Additionally, the operation of payment systems, management of risks and liquidity, insurance and other such services are also central to the activities of financial intermediation. The financial system comprises a multitude of institutions and instruments which facilitate the reallocation of resources within an economy and between countries. Financial intermediation serves three objectives: mobilization of savings and their efficient allocation; facilitation of the efficient conduct of monetary policy with the use of market-based policy instruments; and fostering the development of the private sector. The institutional players include a central bank, commercial banks, merchant banks, discount houses and a host of other financial and non-bank financial institutions, including the capital market as well as numerous types of informal finance. The policy instruments include

interest rate policy, rediscount policy, open-market operations, reserve and liquidity requirements, and refinance facilities. The connecting link between the institutions and policy instruments is provided by a variety of financial instruments, such as deposits, treasury bills, central bank paper, and various other marketable papers of varying maturities.

10. Financial intermediation is a process and not an event encapsulated in a short-time framework; it must be viewed over time as preconditions for its deepening develop, institutions are established, and policy and financial instruments are designed and launched. During this process, the relationship between savers and investors changes from being personal, discrete and bilateral to one that is impersonal, continuous and universal. On the one hand, the choice of the savers as between the financial assets in which to hold their savings expands; on the other hand, investors develop more sophistication in the type of financial liabilities they create to borrow resources and in raising the productivity of their investments.

11. Historically, the development of financial intermediation has proceeded pari passu with the economic development of a country to meet the economy's financial requirements. In the process, the intermediation mechanism grows more varied and complex, ranging from the informal financial system comprising all legal financial activities outside the orbit of institutional and officially regulated finance, to a more complex modern system, supervised by a central monetary authority, that facilitates the transfer of large quantities of money within and between countries.

12. It is useful, therefore, to view the financial intermediation process along definable stages, attributing to each stage the preconditions that must exist for their establishment and sustainability, the policy instruments best suited to that particular stage, and the minimum infrastructure of financial institutions and instruments to sustain that stage.

C. Stages of financial intermediation: preconditions, institutions and instruments

13. For the purposes of the present report, three stages of financial intermediation are visualized: primary, intermediary, and advanced. Of course, the intermediation process is a continuous development and countries do not always fall neatly into one or the other of these categories. But still, for the practical purpose of the report, it is useful to classify countries into discrete groups, based on a review of the prevailing economic and financial conditions, the institutions operating and the instruments used.

14. Macroeconomic stability is an all-pervasive precondition underlying the entire process of financial intermediation. This is proved by the contrasting experiences of South-East Asia, where financial intermediation was nurtured in an environment of relative macroeconomic stability, and of several African countries, where the process faltered in the 1980s because Governments either failed or were unable to implement appropriate policies, leading to high inflation, overvalued exchange rates and macroeconomic instability.

15. The primary stage of financial intermediation is dominated by a combination of a large informal sector where transactions between lenders and borrowers are direct and personal, a currency-creating authority (a central bank or a currency board), and a limited number of deposit-receiving and credit institutions like the commercial banks. At this stage, currency is the main monetary conduit for transactions and the assets held by savers. Generally, investment at this stage of intermediation takes place in those sectors where savings are generated, while in other areas, where savings are insufficient, investment tends to languish.

16. Monetary authorities control money supply through their credit facilities at fixed interest rates, and direct regulation of other credit by prescribing ceilings on credit extended by commercial banks; the informal sector, however, remains outside the direct reach of the authorities. In this stage, the economy is usually characterized by a small number of bank branches per capita, and a high ratio of currency to GDP, and most of the savings are held in the form of currency and bank deposits. This stage of financial intermediation requires the satisfaction of only a few simple preconditions: the existence of a rudimentary regulatory and supervisory framework over the takers of deposits, and a minimum of institutional and technical capacity to carry out the currency-issuing and credit-extending functions, and to collect and interpret limited monetary information.

17. In the intermediary stage of financial intermediation, contacts between lenders and borrowers become less personal, and direct forms of lending and borrowing are replaced increasingly by indirect channels. Further, the assets portfolio in the economy becomes diversified to include term bank deposits, in addition to currency and demand deposits, and some other financial assets, such as certificates of deposit and other short-term money market assets. This stage of financial intermediation is reflected in a higher ratio of M2 (currency plus total deposits) to GDP and a lower ratio of M1 (currency plus demand deposits) to GDP, than that which prevails during the first stage of intermediation. The predominant institutions, in addition to the central bank and (larger number of) commercial banks that operate at this stage, are discount houses, merchant banks, leasing firms, hire/purchase houses, and other short-term financial asset-holders that together constitute a money market. Various types of financial institutions operate with different kinds of credit instruments, and the market for credit tends to become organized and unified and exposed to market forces. Interest rates become the main instrument of monetary policy and the monetary authorities pursue a market-oriented interest rate policy to make the holding of financial assets more attractive than non-financial assets.

18. The interest rate policy at this stage relies less on direct regulation of the level and structure of interest rates and more on indirect policy instruments such as treasury bill auctions and bidding for central bank paper. This development is facilitated by the establishment and development of a money market where treasury bills and other short-term paper are traded. The sustainability of this relatively sophisticated stage of financial intermediation, however, is dependent on the existence of a number of preconditions that include an appropriate regulatory and supervisory legal framework, competition among banks (and non-bank financial institutions), a stable foreign exchange market, and a strengthened central bank in terms of its

monetary management capacity, well-organized internal information flows and accounting standards. A corresponding sophistication also takes place in the institutional structure and financial practices of the informal sector, but its role and importance are generally on the wane.

19. The third, advanced, stage of financial intermediation is characterized by proliferation and diversification of financial assets that include bonds and equities issued by the private sector, and different types of money and capital market instruments. During this stage, new financial institutions are established to include mutual funds, bond markets, and the pension and insurance funds and other financial institutions associated with the development of secondary markets in treasury bills, and government securities, and a full-fledged capital market. They all participate in the financial markets, and monetary policy is then conducted through the use of indirect policy instruments, necessitated by the liberalized interest rate structure, and liberalized foreign exchange dealings. The prerequisites for such a deepening and diversification of the financial systems include: sustained progress towards macroeconomic stability, a market-oriented economy that is responsive to incentives and adaptable to external and internal shocks, and appropriately strengthened regulatory and prudential framework, viable financial institutions, well-established flows of complex financial information, and managerial skills relevant to financial operations (see annex, table 1).

20. The improvement of financial intermediation does not proceed in a linear manner from one stage to the next. Thus, the establishment of any particular institution or the implementation of any specific policy instrument does not necessarily coincide with the attainment of the corresponding stage of financial intermediation. It is rather a common observation, across Asia, Latin America and Africa, that countries that may be characterized as belonging to one stage of intermediation often possess institutions and employ instruments usually to be associated with another stage. For instance, there are cases of countries, classified as belonging to the primary stage, which have established equity and bond markets and venture-capital companies. Similarly, several African countries are implementing interest liberalization policies even when the number of participants in the money market is limited and market conditions are far from being competitive. With appropriate safeguards, these trends are to be encouraged. Among other benefits, they do help to further the institutional structure and to establish proper motivation for the savers and investors, and prepare the countries to handle additional tasks more easily as financial intermediation is deepened. By highlighting the need to strive simultaneously for the creation of a supportive institutional and policy environment for those partial initiatives, the above categorization signals that without them these partial steps may fail to advance intermediation in a sustainable manner.

III. THE AFRICAN SITUATION: AN OVERVIEW

A. Recent developments and financial sector reforms

21. With few exceptions, the financial systems in Africa remain unsophisticated, and both narrow and shallow. While historic factors such as the low level of African incomes and inadequate domestic technical expertise and

capacity explain a part of this situation, it is also the general perception that inappropriate macroeconomic policies, combined with an antiquated and ineffective legal, regulatory and prudential framework, have been the main impediments. Until recently, many African countries, in view of their belief in government interventionist policies, applied direct instruments of monetary control, including interest rate controls and directed credits, which appeared to have considerable appeal for policy makers in those countries but were also found subsequently to have caused unanticipated disintermediation.

22. In addition, almost from their inception, central banks, as guardians of monetary stability, have been by and large weak; they lacked autonomy and became lenders of first, rather than last, resort to both the Governments and the economy. Only a few commercial banks operated in Africa and their lending was largely directed by Governments to the public sector and to what were identified as the "priority sectors". A general feature of the banking system in Africa is proliferation of commercial bank branches in disregard of profitability, particularly as it concerned the State-owned banks which still dominate the African scene. To encourage capital investment, interest rates were kept artificially low, and even lower rates were paid on savings. However, this served to discourage savings. Additionally, the monopolistic position of banks rendered them non-innovative in the design of intermediation instruments, customer service provision and in training professional bankers. Combined with the poor performance of "priority borrowers" and continued government deficits, these factors led to the following:

(i) Weak and rigid balance sheets of central banks with few revenue-yielding assets, large revaluation accounts and accumulated losses, and eventually unreliable accounting and information flow patterns;

(ii) An even weaker and unsound banking system, with heavy exposure to the public sector and problems of non-performing assets in their portfolios, whose extreme condition was manifested starkly in Benin and Guinea, where the financial system experienced complete collapse, and by the experiences of Côte d’Ivoire, Senegal, Uganda and the United Republic of Tanzania;

(iii) An apparent alienation of the formal financial system from indigenous economic actors, especially in the rural areas, and in the urban informal sector and small-scale enterprises.

23. One of the important characteristics of the financial systems of Africa is the coexistence of both State-owned development banks that specialize in financing the development of specified sectors and privately owned long-term financial institutions. The sources of financing development banks in almost all the countries have mainly been the equity and loans provided by Governments and foreign donors. These banks thus have not engaged in domestic savings mobilization and have contributed little to the development of marketable paper. Further, since most of their financial liabilities were denominated in foreign currencies, they suffered heavy losses when their respective national currencies underwent sharp depreciation. Like commercial banks, they also suffered further damage from the performance of poorly managed public sector enterprises.

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24. Another important characteristic is the existence of a large informal financial system alongside the formal system. Demand for services provided by the institutions operating in the informal system continues to be high, particularly among rural dwellers and urban low-income earners, and micro-enterprises. Their savings mobilization potential is high, their procedures and conditions for lending, although at extremely high interest rates, are carried out through mutual trust and gentlemen’s agreements. A disproportionate share of their lending is reported to be for purposes of household consumption.

25. Many African countries witnessed stagnation in the process of financial deepening, and some even experienced pronounced financial disintermediation. This, of course, did not mean the disappearance of existing institutions or instruments. For example, treasury bills remained an important part of the portfolio of financial institutions and the central banks continued to "operate" monetary policy and monetary control. Rather, what happened was that these operations could not be conducted even with a minimum degree of economic efficiency, and public confidence in the domestic banking system continued to erode.

26. Faced with such a situation, a number of African countries have undertaken financial sector reforms, generally in the context of stabilization and structural adjustment programmes supported by financial and technical assistance from IMF and the World Bank. The monetary management capacity of central banks has strengthened, and their internal information flows and accounting practices have improved. Almost all African countries are shifting from the use of direct instruments to indirect instruments of monetary control, lifting regulations on interest rates and developing markets for government paper; in Ghana, Kenya, Malawi, Morocco, Uganda, Zambia and Zimbabwe, for example, the central banks have taken steps to make such a transition to indirect methods of monetary control through treasury bill auctions. Further, except for countries belonging to the monetary unions of the African franc zone-West African Economic and Monetary Union (WAEMU) and the Central African Economic and Monetary Area (CAEMA), many of the countries have also moved away from fixed exchange systems, adopting floating exchange rates through auctions and foreign exchange bureaux. In 1994, even the members of the WAEMU and CAEMA countries also devalued their currencies by 50 per cent in foreign currency terms. On the institutional front, financial markets are being developed and diversified, a more competitive environment is being fostered through easing entry requirements for new banks, restructuring and strengthening existing banks and other financial institutions, and liquidation or privatization of other problem banks. A broader range of monetary instruments and procedures has been introduced. Supervision and prudential regulations are also being strengthened. According to a World Bank study, out of 34 Sub-Saharan African countries surveyed in 1994, more than half had made progress in implementing financial reforms along these lines.

27. As a result of these efforts, financial systems in many African countries have been stabilized and some countries have registered visible progress towards enhancing financial intermediation and the efficiency of the financial system. Countries have also simultaneously pursued macroeconomic policy reforms and addressed the underlying policy miscalculations that led to their earlier problems. Favourable results from such policies are already evident, not only

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in the financial sector but also in the real sector. Thus, in a report circulated to the 1995 annual session of the Economic and Social Council in Geneva, the African Department of IMF stated that as the number of Sub-Saharan African countries undertaking comprehensive and strong adjustment efforts had increased, the region's economic performance had improved. Those countries had achieved higher rates of GDP growth, higher rates of savings and investments, and lower inflation. 1/ The situation is nevertheless fragile, underlying the need for the continuation of adjustment efforts in these countries and their extension to other African countries that have not yet implemented the required economic reforms.

B. Classification by stages of intermediation and their common characteristics

28. Despite the recent progress achieved in implementing financial reforms, financial systems are among the weakest sectors in these economies and remain at primary or intermediate stages of intermediation. Based on an examination of several indicators such as the ratio of broad money to GDP and the proportion of savings held in the form of broad money (see annex, table 2) and the institutions and instruments actively employed, African countries have been classified under the three broad categories of financial intermediation discussed earlier. Of the 41 countries so classified, nearly half (20) are still at the primary stage, 19 are at the intermediate stage and only 2 (Mauritius and South Africa) may be said to be at the advanced stage.

29. The broad characteristics of the African countries in each of these three stages may be summarized as follows.

30. In the primary stage, the ratio of money supply to GDP of the countries is generally less than 0.2. Quasi-monetary instruments are largely represented by interest-earning savings and time deposits, but their role in the mobilization of funds is very limited. The number of commercial banks is limited and the ratio of bank branches per capita is extremely low. Banks exhibit low flexibility in reducing administrative barriers and use procedures that discourage many savers at the margin from using banking facilities. Accordingly, a number of informal and semi-formal financial intermediaries exist that serve particularly the needs of households and small savers, in urban and rural areas. These countries also have contractual savings institutions that are a good source of medium- and long-term financing but are located mainly in the capital cities and usually without a significant network of branches. The lending instruments are also limited and consist mainly of credits extended by commercial banks. The preference for liquid assets leads to the predominance of advances, short-term credits and a small amount of treasury bills in the portfolio of commercial banks (in the countries of WAEMU, for example, short-term credits average more that 50 per cent of credit to the economy, with the ratio being as high as 90 per cent in Niger). Their preference for liquid assets and short-term credits leads them to provide self-liquidating loans for commercial activities and services, averaging between 55 and 60 per cent of the bank's lending. Hence small- and medium-scale enterprises, as well as rural and agricultural projects, tend to depend on informal and semi-formal institutions.

As is to be expected, many countries at the primary stage generally apply direct monetary control.

31. In the intermediate stage, the African countries concerned have tended to promote competition, enhance efficiency and widen the range of instruments available. While commercial banks continue to dominate the financial systems at this stage of intermediation, there is increased competition to mobilize savings and to extend credit. The number of banks in these countries has generally increased. The ratio of currency and demand deposits to broad money supply stands at about 60 per cent. The ratio of broad money to GDP ranges from 20 to 40 per cent, although there are a few exceptional cases, such as Ghana, falling outside the range. Some Governments in these countries have legislated increases in the capital base of the banks (for example, Nigeria) and/or established deposit guarantee schemes (for example, Kenya and Nigeria) to provide security and added incentive to savers. Other measures include stronger supervision of banks and provision of rediscount facilities at the central bank to accommodate the liquidity needs of the banks. Contractual savings as well as securities and other tradable instruments have also acquired increased popularity. The informal sector has maintained its innovative and dynamic character, as evidenced by the appearance of new institutions and mechanisms in its semi-formal subsector (see sect. IV below). These institutions, therefore, remain important mobilizers of household savings and providers of consumer and micro-enterprise credit. Further, linkages have developed between the institutions in the formal sector and those in the informal and semi-formal sectors, especially in the form of deposits of idle balances of the latter with the former.

32. Parallel with this, these countries now have a wider variety of financing instruments, permitting the mobilization of longer maturity deposits and the extension of credit in higher amounts and longer maturities. New institutions such as discount houses, merchant banks, export-import banks (as in Nigeria) and venture-capital companies have emerged that facilitate the term transformation of loans. Together with the previously existing financial institutions, the new institutions have provided these countries with the building blocks for an institutional infrastructure for securities market development with its two components: the money market and the capital market. It is, however, the money market that has developed first, dealing mainly in short government instruments such as treasury bills. Money market development has also facilitated the introduction of other instruments such as interbank deposits, bankers' acceptances, certificates of deposits and commercial paper issued by the non-financial corporations. As against the rather sophisticated development of the money market, few countries in the intermediate stage have established capital markets. Those which have (including Botswana, Côte d'Ivoire, Ghana, Kenya, Nigeria, Zambia and Zimbabwe), however, have generated only a small amount of capitalization. As concerns the instruments, the development of the money market in these countries has facilitated the implementation of indirect monetary control and, therefore, most of these countries have reduced their reserve requirements and rely on the use of the open-market type of operations and on enhancing the flexibility of interest rates. Some of these countries, (for example, Ghana) have introduced auctions of central bank paper to supplement those of treasury bills, and their central banks have established

discount windows to assist banks directly, or indirectly through the discount houses.

33. The advanced stage of financial intermediation is as yet a rarity in Africa, and strictly speaking only South Africa could be said to belong to this category. Nevertheless, Egypt and Mauritius also have most of the institutional structure and instruments of this advanced stage and can be considered close to that stage. These two countries are characterized by a range of institutions and instruments that is reflected in high financial savings mobilization and investment financing, especially of the private sector, through various instruments. Thus, in South Africa, the ratio of credit to the private sector is high, assisted by the availability of a variety of instruments for financing private enterprise. There is also an extensive set of financial institutions, an emerging venture-capital market and a sophisticated stock exchange. However, an interesting feature to note in the case of South Africa is that informal savings schemes (revolving savings and credit associations (ROSCAS) type) are reported to have risen dramatically in number between 1989 and 1994.

34. An interesting feature relating to the classification of countries is observed in the two CFA franc monetary areas: WAEMU (comprising Benin, Burkina Faso, Côte d'Ivoire, Mali, Niger and Senegal) and CAEMA (comprising Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea and Gabon). Each area is served by its respective common central bank, which issues common currency that circulates freely within the respective member countries. A common monetary policy is applied in each monetary area and the monetary authorities have established other common monetary rules and regulations as well as an area-wide interbank market. In both areas, financial reform programmes have included measures to strengthen the supervision of banks through the establishment of a commission bancaire that accompanied the progress of financial restructuring in these countries. Yet, despite their common institutions and instruments, only Cameroon in CAEMA, and Côte d'Ivoire and Senegal in WAEMU, are characterized as belonging to the intermediate stage of financial deepening, with the rest of the countries still at the primary stage. This contrast illustrates the point that financial deepening is not merely a matter of establishing institutions and instruments but also of making corresponding changes in the real sector through macroeconomic and other measures, such as adjustment of the real economy and restructuring of public enterprises. For the CFA countries, the recent change in the parity of the CFA franc, accompanied by other structural and stabilization measures, has created the opportunity to deepen financial intermediation - an opportunity that the authorities in these countries are pursuing vigorously.

C. The unfinished agenda

35. In pursuing their goal of advancing the degree of financial intermediation, African countries face several constraints. First are the constraints in the area of central banking relating to their independence, research and policy formulation and implementation, internal organization and information flows, and decision-making. Second are the constraints in the area of financial institutions relating to the yet incomplete restructuring and strengthening of commercial banks and other non-bank financial institutions, encouraging

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competition among banks, downsizing of public ownership of financial institutions, improving their management, and changing their "culture" to reorient their deposit mobilization and credit allocation attitudes (including the attitude towards women clients) and practices to meet the specific circumstance of African economies. Finally, there are the constraints in the area of real economy, such as encouraging market-based structures, restructuring, privatizing, and improving the financial performance of public enterprises.

36. Along with the above constraints, it may also be noted that so far the financial reforms in Africa have tended to focus almost exclusively on the formal finance sector, to the neglect of the informal sector. The potential of this sector in mobilizing savings, in financing micro-enterprises, and in extending finances to other neglected sectors and population groups remains to be actualized; Governments, international donors and institutions need to address this issue as a matter of a priority and as an integral part of financial reform programmes. The present report makes several recommendations in this regard in the following section on informal finance, and these are followed by a proposed three-pronged strategy to develop the formal financial system.

IV. THE INFORMAL FINANCE SYSTEM

A. The system and its importance

37. In most African countries, the informal finance system mediates a significant amount of financial transactions, both deposits and loans. The participants in this system derive their operational modalities from the country’s tradition and local culture, and on the basis of an intermediating financial technology adapted to the country’s circumstances. Transactions are generally personal in nature and conducted on the basis of trust and intimate knowledge of customers. This sector satisfies flexibly some of the financial needs that would remain unmet if sole reliance were placed on the existing formal system.

38. The informal system comprises two broad subsystems, one consisting of purely informal institutions and arrangements that do not fall within the direct purview of monetary or regulatory authorities, and another comprising semi-formal institutions and arrangements that operate under licence, and have some linkages with the formal financial system. They are influenced by national monetary policy and may therefore fall within the limited purview of monetary authorities.

(a) Informal financial system

39. There is a wide variety of arrangements in the informal system. At least six types of this system are common in most countries, ranging from transactions that are largely social and personal to those that are at least partially commercial and impersonal: friends and relatives; moneykeepers; merchants and traders that advance loans and sell goods on credit; moneylenders, and two broad

types of group-based deposit and lending arrangements (ROSCAS and accumulating savings and credit associations (ASCRAS)).

(i) Friends and relatives

40. Friends and relatives are the first option for financial assistance, especially in Africa where extended family arrangements are common, public social safety nets are poorly developed and financial insurance is not readily available. Five features of these transactions are noteworthy: reciprocity ("I help you, you help me, when in need"); insignificant transaction costs; the open-ended (no fixed maturity) nature of many of these financial contracts; the informality of screening devices (personal knowledge of borrowers) used in making loans; and the informal sanctions (such as social shunning of delinquents) employed to enforce contracts. The popularity of these loans may be illustrated by the finding of a survey conducted in northern Nigeria in 1988 that 97 per cent of informal sector loans by value were between friends and relatives. Collateral is seldom used and virtually all loans are confined within the boundaries of an extremely small social group, pointing to heavy reliance on interpersonal flow of information and reliance on kinship and village sanctions as a mechanism for enforcing repayments.

(ii) Moneykeepers

41. Many people in Africa, especially in rural areas keep their savings with moneykeepers. The moneykeeper is usually a respected person in the village. No interest is generally paid on deposits and depositors may have to pay a safe-keeping charge to the moneykeeper. In some cases, the funds are deposited by individuals who have relatives residing outside the village and who send remittances periodically to the villages. In other cases, depositors may be accumulating funds to purchase property or to invest in an enterprise.

42. The advantages of this type of arrangement are safety against theft, confidentiality, liquidity and the free advice and other services the moneykeeper may be willing to provide to the saver. The disadvantages are obvious: the cost instead of earning from the deposit of savings, and the risk of default. Where moneykeepers are active it is a strong indication that the financial system is doing an extremely poor job of providing deposit services.

(iii) Merchants and traders

43. Another important form of informal finance in Africa is the loans made by participants in marketing systems. Many merchants and traders commonly sell their goods on credit. This type of lending can be found embedded in most marketing systems and can flow either up or down the system. For example, a fertilizer importer in Ghana may have access to lines of credit from a commercial bank to finance his activities. The importer, in turn, may sell fertilizer to wholesalers on credit, who also sell to retailers on cash and credit terms, and then retailers sell fertilizer to farmers on cash and credit. In effect, the formal line of finance used by the importer finances, at least partially, the secondary and tertiary informal lending done by wholesalers and retailers.

44. Although less common, some informal lending is also done in the reverse direction, where a farmer may give his goods to a broker on consignment who, in turn, sells them to a wholesaler on a deferred payment basis, and so on up to the retailer.

45. Several features stand out in this type of financing. Entrepreneurs in the marketing system are able to realize economies of scale by providing varied financial and marketing services. As lenders, they also capitalize on the knowledge they accumulate from non-financial transactions with potential borrowers to screen for their creditworthiness.

(iv) Moneylenders

46. Typically, moneylenders in Africa have only a few clients, make small loans for short periods of time, and also charge high interest rates. In many cases, moneylenders operate sub rosa in commercial centres or markets. Some of the informal moneylending is also associated with pawning, that provides lenders with secure collateral for loans. In Ghana, for example, farmers are known to pawn the use of rights to their cocoa trees to lenders. Pawning, however, is less common in Africa than in other areas of the world.

(v) Group-based savings and credit associations

47. Many people in Africa participate in self-help financial groups of two types: those (ROSCAS) that collect funds periodically and immediately allocate the funds collected, in rotation, to one of the group members, and others (ASCRAS) that accumulate funds from group members for diverse uses, including lending. Often the same generic term is used to label both types of association in Africa. In South Africa these groups are called stokfels, in Ghana susus, in Cameroon and Niger tontines, in Egypt gameya, in Ethiopia ekub (with a clear terminological distinction between iqqubs, which are akin to ROSCAS and iddirs which are ASCRAS), in Nigeria esusus, and in Tunisa the sanduk.

48. ROSCAS, although they receive savings from members, hold no cash since the cash received is immediately distributed to members in rotation. The rotation is usually determined by lot; the first person receiving the pot obtains an interest-free loan from other members of the group and then repays the loan in equal instalments through contribution in subsequent rotations until the loan is entirely repaid in the last rotation. The final person to receive money in rotation is a clear saver, just as the first person is the clear user of savings of the group; the status of persons in between as net savers would depend upon their turn in the rotation. Technically, a ROSCA is self-terminating when the last person in the rotation has received his money and all other persons would have repaid their loans. In practice, however, ROSCAS tend to continue with fresh cycles of rotations.

49. ASCRAS are formed for a variety of reasons; they collect funds regularly or on an ad hoc basis, and use the funds for numerous purposes, such as emergency loans to members, for group purposes, and loans to members or even non-members for micro-investment projects. ASCRAS, unlike ROSCAS, are not self-liquidating and some of those groups evolve and link themselves to, or become part of, the formal financial system.

50. A variety of reasons explain the popularity of these self-help groups. They impose few transaction costs on members, build mutual trust, provide insurance or reciprocity, allow members to access relatively large amounts of funds that may otherwise be difficult to assemble, and provide a desirable form of compulsory savings. In practice, they have also shown great flexibility and innovative ability in the services they provide, as evidenced by the existence of various types of institutions and their organizational structures. As financial institutions, they combine the characteristics of commercial banks and of short-term financial markets. Their popularity demonstrates that relatively poor people are able to save, that they are willing to meet their financial obligations diligently, and that local communities are able to invent and manage ways to meet their financial requirements. Indeed, these group savings associations offer the greatest potential for developing as important mobilizers of savings and as facilitators for efficient allocation.

(b) The semi-formal financial system

51. The semi-formal financial system comprises institutions that are licensed but do not generally fall within the regulatory and supervisory authority of the central banks or other designated government agencies. It comprises the postal system, credit unions, other cooperatives, a variety of financial institutions run by non-governmental organizations (NGOs), rural- and community-based banks, finance companies, and venture-capital firms. Even in small countries there may be a dozen of these organizations providing loans and mobilizing deposits. During the past decade, this segment of financial systems has been increasing rapidly in many African countries, through both new entrants and the evolution of informal sector organizations into semi-formal institutions.

(i) The postal system

52. In most African countries, the postal system provides the only formal deposit facilities that are accessible to a large proportion of the population, particularly in the rural areas. Only fragmentary information on a few countries’ postal systems is readily available that describes the current condition of those systems. For example, in the Gambia there were approximately 35,000 savings accounts in the postal savings system in 1988; in the Republic of Tanzania, the system held about 10 per cent of all formal deposits in the country; and in Namibia, the postal system had about 67,000 savings accounts in 1994.

53. As a general practice, the postal system accepts small deposits and forwards these funds directly to the Ministry of Finance or the central bank, or to a government-owned savings bank. In Ghana, for example, a National Savings and Credit Bank has been formed out of an old postal savings system. In most of the French-speaking African countries, the postal system has experienced difficulties related to liquidity and inter-account transfers. In yet other countries, such as Uganda, the postal system is essentially moribund after a long period of neglect and decline.

54. A postal savings system has several advantages and disadvantages. It imposes modest transaction costs on the saver, its geographically widespread network reduces the time for making deposits, and it provides confidence and

security to savers by its implied government guarantee. Its disadvantages are mainly related to its linkage with government and its bureaucracy, that imposes long withdrawal procedures and delays, indifferent customer service, and low interest rates on deposits.

(ii) Credit unions and cooperatives

55. At the end of 1993, there were more that 20,000 credit unions registered in Africa, with over 5 million members. They had mobilized deposits and share capital equal to about US$ 500 million and had outstanding loans for a somewhat smaller amount. Twenty-eight countries had national federations of credit unions that were affiliated to a regional credit union organization (ACCOSCA). Several other countries, such as Niger, have credit unions but lack a national organization that would enable affiliation with ACCOSCA. About one quarter to one third of these credit unions are financially strong, another third are struggling and still another third are moribund or insolvent. In the late 1980s, several of the strongest and largest credit unions were located in Cameroon, Rwanda and Togo.

56. Besides credit unions, some cooperatives also provide financial services in Africa. Examples are multi-purpose cooperatives in Kenya, farmers’ cooperatives in the Gambia, and rural cooperatives in Mozambique. However, such cooperatives may now be providing fewer financial services than they did several years ago and relatively few are involved in the mobilization of voluntary deposits.

57. Credit unions and cooperatives have several attractive features. They are grass-roots organizations that make small loans and mobilize micro-savings efficiently. They have also evolved management and supervision techniques that work in diverse cultures. They usually maintain low overhead by drawing on volunteer labour and donated facilities. Most of those small credit unions and cooperatives also combine lending and deposit-taking; an individual must first save before receiving loans.

58. Although they have several attractive features, these institutions also have weaknesses. The ownership of the organization is often obscure and the board of directors may not always act in ways that are consistent with the overall interests of members. Larger credit unions may also encounter liquidity management problems if they are not connected to a more extensive financial network. Credit unions that draw their members from groups involved in the same economic activity can also be damaged by adverse events that affect most members.

59. Experience has shown that credit unions take time and patience to build, yet only a short time to debilitate. A recent pilot project in Niger, for example, involved spending several years in carefully building foundations for about 48 new credit unions by focusing entirely on deposit mobilization. Only after a foundation had been built on share capital and deposits did the credit unions begin extending loans.

(iii) Non-governmental organizations

60. In recent years, numerous NGOs offering financial services have emerged in many areas of Africa. In numerous countries, NGOs, generally funded by donations (both domestic and external), now constitute the segment of the financial system that is changing most rapidly, and carrying out the most experimentation. They have developed techniques of lending short-term and small amounts, and as financial intermediaries provide a useful addition to the financial systems in Africa.

61. Only fragmentary information is available for a few countries that partially document the numerical importance of NGOs and the financial services they provide. In the late 1980s and early 1990s, for example, about 300 developmental NGOs were operating in Kenya, some 350 in Ghana, 126 in Senegal, 108 in the Gambia, 44 in Swaziland, and a few hundred in Zimbabwe. However, only a few among them (for example, 4 out of 44 registered in Swaziland) are involved in credit programmes.

62. A variety of financial techniques and practices are used by NGOs in their credit operations. Many of them are experimenting with group lending of various types, and a number use loan-guarantee funds to stimulate lending by commercial banks to target groups, for example, women. The Ugandan Women’s Finance and Credit Trust and the Kenya Women’s Finance Trust are two of many women’s credit programmes in Africa doing this. A handful of NGOs are also experimenting with Grameen Bank-type practices, in Burkina Faso, for example. A substantial number of NGOs are drawing on lessons from the informal finance system in designing their programmes, the village banks (*visacas*) in the Gambia being an example, while others are replicating and adapting practices of the formal financial system. Some of the NGOs are providing loans at close to, or above, market rates of interest, although others charge concession or even zero interest rate on loans; the Silveira House Farmer Credit Project in Zimbabwe is an example of this practice.

63. Many of these programmes encounter problems, including loan recovery difficulties, high operating expenses, lack of financial management skills, inadequate information systems, and lack of prudential supervision. Aside from the savings clubs in Zimbabwe, few of the NGOs give much attention to deposit mobilization.

64. Loan recovery is part of an NGO sustainability problem, and relatively few of these organizations maintain timely or comprehensive records of their loan portfolio. As loan volumes increase, loan refinancing may mask loan recovery difficulties. Because NGOs are highly dependent on external funds that tend to arrive in surges, borrowers may have less incentive to repay loans after a credit programme matures and there is less likelihood that they would be able to borrow from the NGO again. The fact that NGOs concentrate their lending on individuals who are economically fragile amplifies loan recovery problems when the macroeconomic situation deteriorates.

(iv) Venture-capital firms

65. In a few countries, new venture-capital or risk-capital firms are emerging, sometimes as a result of locally based enterprising efforts and sometimes financed by donors. These firms are typically small, fund only a few enterprises, and often provide short-term loans to complement equity investments. The Ugandan Development Finance Corporation is one example of such firms. Another example is the Common Savings and Investment Fund of Cameroon, with its innovative creation of investment clubs which apportion members' deposits into a Solidarity Fund and an Investment Fund. The Solidarity Fund lends only to members but on the basis of an auction, thus introducing "market" considerations into the lending decisions. The Investment Fund, on the other hand, advances funds to a venture-capital fund in which the members hold shares. "Operations 71", of Cameroon, is another example of a fund having diversified its operations into investment activities. The development of this type of finance, however, comes late in the overall process of financial deepening as the scope of operations of the enterprises expands.

66. Lack of comprehensive and time-series data on the financial operations of the above-described informal and semi-formal system precludes definitive assessment of its size and growth over time. Instead, researchers have estimated its importance by using proxy indicators, such as the ratio of deposits to money supply, the ratio of bank credit to the private sector to GDP, as well as anecdotal evidence. These indicators suggest that the share of the informal and semi-formal sectors in financial activities is considerably higher in Africa than in other developing countries. Thus, in Cameroon in 1988, nearly three fourths of rural financial assets were accounted for by the informal and semi-formal financial system, which held some 20 per cent more deposits than those held in the country's formal banking system. In Zambia and Zimbabwe, around 85 per cent of smallholders have access to informal credit; in Malawi, the non-formal financial system is reported to be about three times as large as the formal system, and in Ghana it is about four to five times more important. 2/ Informal finance is probably the only source of consumer credit in the economy and its role in the financing of start-up and expansion costs is quite large relative to that of the formal institutions (for example, Malawi, Uganda, the United Republic of Tanzania and Zambia).

B. A policy proposal

67. The continued existence and growth of the informal financial system 3/ is attributable to many factors. Institutions (or individuals) in this sector are closer in geographical proximity to their clients (both depositors and borrowers) who, therefore, have ready access to their services; they are able to provide quicker services and to lend without generally demanding marketable collateral; they tend to have lower information and transaction costs; they build mutual trust between lenders and borrowers; and in many instances they provide insurance or reciprocity. In addition, this system fills some of the needs unmet by the formal financial system or substitutes for the formal system when it withdraws or shrinks. On the other hand, informal finance faces a number of limitations, such as lack of economies of scale, narrow range of functions, limited variety of assets and liabilities in the portfolios, mismatch

of risk preferences of the depositors and borrowers, and sometimes the high costs imposed on borrowers. Informal markets that handle high-risk loans charge extremely high interest rates, as high as 20 times, or more, the rates in the formal markets. These high rates may be discouraging borrowing by productive enterprises which could seldom expect correspondingly high profits to service those rates.

68. The above brief catalogue of the relative advantages and disadvantages poses a main dilemma for policy makers. Should the informal system be preserved or gradually phased out by extending the formal system? With few exceptions, so far the national authorities and central banks have tended to ignore the informal financial sector and have concentrated their efforts on promoting the formal sector instead. However, informal financial institutions, in addition to the above-mentioned advantages, exhibit a particular strength in mobilizing savings and meeting the needs of micro enterprises, as well as target groups such as women and landless labour. These sectors and groups are the real priorities of African States and form an integral part of their poverty alleviation strategy, that relies more on domestic than external finance, and targets and creates more productive employment.

69. Thus a strong case can be made for preserving and encouraging the informal system, while addressing its limitations through appropriate policy initiatives and developing and strengthening the formal financial system. This is best achieved if the central banks become the national institutional focus and configure their respective national financial systems to serve the local economic needs and circumstances. A clear distinction, however, must be made between those informal financial systems that have developed as a reaction to regulatory controls or to fill gaps in the formal system, and others that are based on traditional practices. The former will tend to diminish in size as the formal financial system is extended, while it is usually undesirable to formalize the latter.

70. The basic purpose of the proposed policy initiative would be to exploit to the maximum, and in a cost-effective manner, the savings and credit potential of the informal and semi-formal financial system; to strengthen its ability to mobilize small savings from relatively marginal sections of population; and to encourage decentralized lending, that is, in areas largely untouched by the formal financial system.

71. Many of the participants in the informal system will continue to remain outside the purview of the authorities. Parts of the system, such as friends and relatives, moneylenders, and even traders, generally use the stock of their personal savings for lending; they do not mobilize (others’) savings, and their lending operations are akin to investing in individual productive assets. Strictly, therefore, only the savings and credit groups like ASCRAS, credit unions and cooperatives, and NGO-sponsored credit institutions need be covered by this initiative, as financial intermediaries that mobilize savings from one set of members and channel them to another set. They also have the potential, as demonstrated in Burkina Faso, Cameroon and Niger and a number of other African countries, to extend their reach to a larger number of depositors and borrowers, adapt the nature and size of their operations, and foster links with

the formal financial system without losing their identity or forgoing their current comparative advantage over the formal system.

72. The policy initiative should begin with national efforts to seek to determine the overall magnitude of operations and the role of the institutions in the informal sector, to understand how they work and how sets of unwritten rules and social conventions have guided and sustained them against risks inherent in financial transactions. Further research is also needed to understand the savings and investment behaviour of the various actors in the informal sector, their relative preferences for the different types of financial instruments and services, their economic expectations, their evaluation of risks, and their attitude to different risks and rewards for risk-taking.

73. Progress in the development of this sector would depend greatly on the provision of national and (as in the case of CFA franc zone countries) regional support to the operations of institutions such as ASCRAS and credit unions and cooperatives. These institutions could be provided with name identity through licensing and registration, and encouraged to form closer linkages with banks that would give them greater access to credit on a commercial basis which they could pass on to their customers. They should be encouraged to form wider associations or cooperative systems to enable individual member organizations to benefit from the association’s label, and also to prompt commercial banks to extend them credit. This possibility could be realized through the development of an appropriate assets/liability paper (for example, "groups liability") by those institutions which would be transferable and discountable as a collateral and help foster linkages with the formal finance. Further, promising intermediating institutions that attempt to link with the formal financial system could be helped through the provision of management assistance and access to better technologies. The benefits that would accrue from this linkage would be twofold: it would improve the financial management and intermediation processes in the informal sector, and sensitize the formal financial system to the needs and resources of the rural and urban informal economy as well as familiarize them with the "best practices" of the informal financial system that could be replicated by the formal financial system.

74. Semi-formal institutions could also be encouraged to enter the field of venture capital, along lines similar to those in "Operations 71". In time, such venture-capital funds should be enabled to resort to commercial borrowing as the scale of their operations expands. However, caution must be exercised in inviting government or external donor intervention. Such intervention should be demand-based, evolving as the informal institutions develop; in contrast to the successful example of "Operations 71", Cameroon also provides an example of a viable savings group that collapsed once the donors intervened and tried to expand its operations.

75. Central banks can help accelerate the process by developing a common blanket framework of "Articles of association", encouraging provisions such as reserves and periodic publication of accounts, to which cooperatives, credit unions or their larger associations could voluntarily (and perhaps eventually through legal requirements) subscribe. As an inducement, the central bank concerned could provide, free of charge, its supervisory and regulatory services to those institutions that agree to adopt those articles to govern their

operations. The central bank could also provide practical training to the officials of those institutions through on-the-job training in commercial banks and in the central bank, and conduct technical workshops and seminars for the institutions' personnel on management techniques, accounting and financial control procedures. Whether these institutions should be required from the very beginning to register and be regulated formally by the central bank, or whether such a requirement should await the development of these institutions and be gradually extended 4/ to cover the entire spectrum of credit unions and cooperatives, should be decided by the countries on the basis of their individual circumstances, including the technical and personnel resources of the central bank itself.

76. The international community could help to supplement the central bank's resources and capacity, where needed, through assistance in the formulation of the overall initiative, including the preparation of the operational rules and regulations of cooperatives, the formation of technical personnel and the holding of technical workshops.

77. The proposed initiative should also encompass two other parts of the semi-formal system: the postal system and the credit-granting NGOs.

78. The postal system has considerable potential as a mobilizer of financial savings. To realize that potential, the system needs to be reformed with a view to developing it into an independent system that manages its deposit accounts and the investment of these deposits on a commercial basis. Postal savings will only be popular if they offer attractive and competitive rates of return, as well as varying deposit maturities, and provide withdrawal procedures, including transfer of funds, that are convenient for the clients. A possible avenue may be to convert the postal system into a savings bank with active assistance from the central bank and a mandate to operate on a commercial basis.

79. In view of the growing importance of NGOs, and their weaknesses as noted earlier, the proposed policy initiatives should also cover those NGOs that are entering into the business of financial intermediation. Experience has shown that where only grant funds are used, they lead to a poor recovery rate, and that the viability of an institution as a lending institution depends on deposit mobilization being a significant, if not a major, component of its total financial resources. It is in the national interest, as well as in the interests of donors who provide finance to NGOs for on-lending, that these institutions become viable and use the funds provided to them on a revolving basis so that ultimately they become self-financing, assuring their clientele of regular credit facilities. Towards that end, those NGO-led institutions that are expected to remain in the lending business on a permanent basis should be licensed and required to produce a certain minimum of information on their operations on a regular basis. Further, while it may not be possible for a financial NGO to start mobilizing deposits from the very beginning, licensing authorities (and indeed the providers of initial finance) should encourage, if not require, that they move in that direction on the basis of certain indicative targets of deposits mobilized as a percentage of their lending operations. As they enter into business operations, NGOs should also be subjected to some central prudential regulation and supervision. To help NGOs move in this

direction, central banks could provide NGOs with a similar type of assistance to that indicated earlier for credit unions and cooperatives.

V. A STRATEGY TOWARDS PROMOTING FINANCIAL INTERMEDIATION IN AFRICA

A. General considerations

80. The brief survey in section III of existing structures and practices of financial markets in Africa indicated that African countries generally lack fully developed financial markets that could help ensure optimal mobilization and allocation of savings, and permit the efficient conduct of monetary policy - both important conditions for economic growth. Thus, Africa should view the deepening and diversification of financial markets as a top priority for policy makers.

81. Sustainable progress in financial intermediation requires a reasonable degree of macroeconomic stability. However, many of the African countries still suffer from large macroeconomic imbalances, despite the progress achieved recently, inter alia, in reducing inflation, budget deficits, and exchange rate overvaluation in the context of economic reform programmes. Notwithstanding the remaining imbalances, efforts to advance financial intermediation should not be delayed but rather be synchronized with policies aimed at attaining macroeconomic stability. There is ample evidence, including the experience of countries such as Ghana, Kenya, Uganda and the United Republic of Tanzania, that financial reforms and macroeconomic policy reforms are mutually supportive and should be pursued simultaneously.

82. Financial sector reforms may be pursued either gradually or with a "big bang". In the case of Africa, the balance of considerations would seem to tilt in favour of gradualism. This is because certain initial conditions relating, for example, to the availability of a stock of human capital and management systems, appropriate portfolio of financial assets, and information channels, need to be established first. In particular, the development of human capital and management systems is critical; without a skilled and appropriately motivated staff, even the best bank portfolio can turn sour. This process, however, is time-consuming and will achieve results only gradually.

83. Financial sector development is also unlikely to gain impetus if two basic ingredients of the market economy are not put in place: the quality of governance, and clarity in the delineation of property rights. Governance taken in this generic sense is everything that establishes order in a civil society. Freedom of choice and the impersonal nature of transactions are the hallmark of market economies, and the same values should inform the governance in Africa. For this, Governments need to create the right setting and should assume the role of facilitator of the market economy, and not that of its custodian.

84. Property rights must also be formalized if markets are to be modernized, strengthened and expanded. This can be achieved by embodying property rights in universally obtainable, standardized instruments of exchange that are registered in a central system with enforceable legal rules. Property rights can then

enter the market-place in a form adapted to exchange, such as checks, share certificates, promissory notes, bonds and contracts which facilitate the transfer of resources to their highest valued use.

85. There are alternative approaches that can be adopted in Africa: an evolutionary approach or one based on proactive policy. An evolutionary approach consists in allowing financial markets to develop naturally, depending upon the pace of overall economic development and the existing system of incentives, with the authorities intervening ex post mainly through improvements or changes in laws and regulations whenever circumstances warrant them. The proactive approach, on the other hand, consists in authorities providing ex ante a legal, regulatory and prudential framework aimed at fostering and, when feasible, accelerating the development of financial markets. It helps set up mechanisms, institutions and instruments that promote and facilitate this development.

86. A proactive approach may be more suited to the actual circumstances of African countries, for various reasons. First, in African countries market forces are often not strong enough to develop financial markets by themselves. Years of financial repression have prevented market innovation and market initiatives, limited financial diversification and introduced several biases against the working of the market mechanisms and against the private sector. Second, a determining factor of the pace and strength of financial markets development is the country’s institution-building capacity, which in Africa needs to be nurtured actively through official and donor assistance. This is the way, for instance, in which discount houses in Kenya were set up to become the focus for money market development. Third, a proactive approach allows for the use of the most efficient institutional mechanism, for the adoption of a technology appropriate for local conditions and levels of development, and for organizing the required training infrastructure locally. For instance, in Mauritius for a long time the Stock Exchange was in effect only a Brokers Association. Its subsequent institutionalization into an over-the-counter market was natural in the circumstances, in that a formal stock exchange could not have taken root with the initial insufficient volume of transactions and shortage of qualified operators.

87. A proactive policy should address several issues, such as where to start the process, the optimal institution-building path to adopt, the best way to develop new markets, new instruments and asset portfolios, and how to organize financial information flow and its dissemination so that market participants can act efficiently, and what kind of incentives must be put in place. The answers to these questions will depend on the stages of financial intermediation the country has already attained. However, the main point to be made is that such a policy guides the financial institutions in a market-oriented direction, by removing obstacles in their path, promoting contractual savings institutions, tailoring new savings instruments to the preference of the savers, and inducing changes in the operational culture of the banks so as to enable them to respond to the local conditions in Africa.

B. A possible strategy

88. Efforts to promote financial intermediation in Africa should encompass both the development of the informal and formal systems and the interlinkages between them. The previous section dealt with the informal system. The present section proposes a strategy to develop the formal system.

89. African countries may consider pursuing a three-pronged strategy to develop the formal financial sector: strengthening and promoting various bank and non-bank financial institutions, devising and promoting the development of a variety of financial papers, and developing and implementing indirect instruments of monetary policy. Careful consideration should be given to the appropriate mix of institutions, assets and instruments designed to serve monetary objectives at each stage of intermediation.

90. The proposed strategy takes into account the financial reforms already undertaken by African Governments, but suggests that further measures be more comprehensive, addressing simultaneously the issues in those three areas as well as ensuring that the needed preconditions for their sustainability are in place, depending on the stage of intermediation reached.

91. Three over-arching issues will confront the authorities during each stage of financial intermediation: the status and technical capacity of the central bank, the financial health of the banks and non-bank financial institutions, and the legal, regulatory and prudential framework.

92. The central bank has a crucial role to play at each stage of financial intermediation to nurture and supervise, and to develop the financial system. The central bank must be constantly in a stage of evolution itself: to keep itself equipped to meet its tasks as the monetary policeman of the economy. Accordingly, restoring the central banks in Africa to their primacy in financial management should be considered the most crucial. The core of human resources and skills should be directed first of all towards improving the operational and management capabilities of the central banks in keeping with the development of the financial markets.

93. The financial health of the banks is equally critical for further financial deepening. Commercial banks are the base on which financial deepening takes place. As the experience in Africa has shown, weak banks erode public confidence in the financial system and lead to disintermediation. Restructuring of failed banks is a costly proposition and both the banks’ management and the central regulatory authorities must be constantly vigilant to see that the banking operations are conducted prudently and on a commercial basis, and that accounting and auditing standards are strengthened. African experience has also shown that restructuring and recapitalization of banks without corresponding adjustments in the real sector, such as restructuring of public enterprises, often fails and even backslides.

94. Prudential and supervisory regulatory frameworks must also be kept constantly under review to ensure the strength of the financial system. The content and complexity of these regulations must be appropriate to the existing degree of financial intermediation, neither so restrictive as to prevent

competition and development of innovative institutions or practices, nor so permissive as to allow the establishment and operation of shadowy and shaky financial institutions. The experiences of some CFA franc countries, as well as of others like Ghana and the United Republic of Tanzania, illustrate that improvements in prudential frameworks, along with strengthening of supervision, must proceed pari passu with the progress in financial deepening. Regional considerations may also influence the types of regulatory frameworks that African countries may adopt. Membership in common monetary areas will dictate that member countries embrace a common, region-wide, regulatory framework. Similarity of regulatory and prudential framework may also be desirable, however, even for countries not forming part of a common monetary area, in order to avoid "competitive" inducements for the entry of foreign banks, as well as to permit a greater intercountry/interbank flow of funds conducive to the emergence of geographically wider financial markets in Africa.

95. The wide diversity in the degree of financial intermediation prevailing in the African countries necessitates that any general strategy be adapted to the circumstances of each country. The following proposals highlight some of the crucial steps relevant to each of the three stages of intermediation that will need to be further fashioned to fit the needs of specific countries. The strategy should be implemented in each country drawing upon the best practices in the region as concerns the development of particular institutions and instruments.

96. During the first stage of intermediation, the prime objective of the central banks is to meet the liquidity needs of the economy through the issuance and circulation of adequate amounts of currency, and to ensure the solvency of commercial banks. The central bank is the main source of credit to the government as well as to the commercial banks. Interest rates are fixed by the central bank, as is the amount of credit it would extend to the economy. As there can be no "market" at this stage of intermediation, the central bank needs to estimate the demand for money (by drawing simple statistical relationships between money and income) and the corresponding requirement for base money (via the money multiplier). For this purpose, central banks have to be equipped with appropriate research and operational capacity. In addition, they should possess the manpower to supervise commercial banks with the objective of ensuring the security of deposits to foster confidence in the banking system. To perform these functions efficiently, central banks need to be independent of government interference and maintain healthy balance sheets themselves.

97. Many central banks in Africa, especially in countries at the first stage of financial intermediation, do not exhibit this ideal view. The first priority, therefore, must be to reform and strengthen central banks, institutionally and financially. Central bank legislation should be modified appropriately to recognize their autonomy explicitly, and the various development banking and other quasi-fiscal functions should be removed from their operations. Strengthening them financially requires that they be relieved from the accumulated claims on government and on distressed financial institutions that burden their balance sheets. A good example of how this can be done may be observed in Ghana and the United Republic of Tanzania. In Ghana, the revaluation account of the central bank was replaced by a bond issued by the Ministry of Finance with the understanding that all new additions to the

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revaluation account would be settled in cash by the Treasury. The bonds carried a below-market interest rate to provide an income flow to the central bank to ensure its financial autonomy. Bad assets of the central bank arising from non-performing loans of public enterprises were eliminated through various devices. In the United Republic of Tanzania, the new Bank of Tanzania Act makes the Bank virtually independent of the Government, creates various mechanisms and obligations to ensure proper accountability, and makes the achievement of monetary stability the primary objective of the Bank. Simultaneously, its organization was restructured, and better accounting and auditing procedures were introduced. In countries where the central banks are still weak and financially distressed, reforms along these lines would lay the basis for advancing intermediation.

98. The banking system in many of these countries at the primary stage of financial intermediation is equally weak, carrying large amounts of non-performing assets. Thus, apart from the strengthening of the central banks, restructuring and recapitalization of banks are essential for creating a dynamic and competitive financial system. While many African countries have gone through this process, in some countries the process has been stalled because of the costs inherent in such restructuring and the budgetary constraints faced by the Governments. Donor countries and international financial institutions could provide appropriate financial support to meet the initial costs of such restructuring.

99. Restructuring of banks should be based on a comprehensive audit of accounts and on a transfer of their non-performing assets to another recovery agency and replacement by government bonds. Banks should then be recapitalized to meet progressively the Bank for International Settlements (BIS) capital: assets ratios. Simultaneously, they should be subjected to rigorous reporting requirements and brought closely under the supervisory eye of the central bank. Restructuring of weak banks should be accompanied by reforming state-owned banks through decentralization of their operations, and by subjecting them to competition with easing of restrictions on the entry of new banks. The aim of this effort should be to restore the solvency of commercial banks and public confidence in the banking system, thereby creating both a demand and an opportunity for new entrants into the banking arena. A relevant issue concerns the need for deposit insurance. On the one hand, such insurance could build confidence in financial savings. On the other hand, it may be costly if the banking supervision function is not exercised rigorously and the legal framework not developed.

100. African countries that have made notable progress in recent years to halt and reverse the financial disintermediation and distress that characterized Africa in the 1980s are now in a position to advance their financial systems further into the second stage of financial intermediation. Four successive steps may be envisaged in this process: the establishment of a clearing-house, the setting up of an interbank market, the creation of a primary market in treasury bills and other short-term private bills, to be followed by the development of a secondary market in those bills. The successful implementation of these steps requires the entry of additional banks and other non-bank financial institutions into the financial system, the creation and promotion of new financial assets, and a move away from directed credit to the use of

instruments of indirect monetary policy within a monetary programming exercise. These actions must, of course, form part of the continuing efforts to improve general economic efficiency and achieve macroeconomic stabilization in the framework of a liberal market-friendly economy. An important complementary element of this effort should be the reform of state enterprises with a view to restoring their financial viability and thus increasing their potential to participate in the financial markets as both lenders and borrowers.

101. The tasks of the central bank will be more varied and complex during this stage than in the primary stage of financial intermediation. It must initiate and encourage the development of financial paper that is flexible and market-oriented, further formalize its relations with commercial banks, be provided with enhanced powers of supervision and regulation over banks and other financial intermediaries, be equipped to formulate and implement monetary programming, and define precise rules for accessing central bank credit, including a posted rate on its refinancing facilities.

102. The establishment and proper functioning of a clearing-house is a sine qua non for exchanging among banks primary financial claims represented by checks, drafts, travellers' checks and other liquid payments instruments. Generally banks are owed, or owe, substantial amounts of money through a payments system which may not appear on bank balance sheets and which subject individual banks to exposure to payment system risk if a debtor bank fails. This risk is a function of the size of the payment and the length of time it takes to clear the payment. Banks would be more willing to hold a short-term claim on each other if they were financially strong and not perceived as likely to have liquidity and solvency difficulties, and if there existed a well-functioning and efficient clearing-house mechanism that avoided long interchange and settlement periods and, thus, large floats and repayment risks. The clearing-house should have a transparent set of rules and regulations that specify the process of settlement, the maximum time it takes to clear funds to payees, and the maintenance by the member banks of positive cash balances with the central bank.

103. With a well-functioning clearing-house, the next step would be the establishment of an interbank market where commercial banks borrow short (overnight) from each other. For such a market to evolve, the central bank should cease its accommodating role, thus obliging commercial banks to meet their short-term liquidity needs from each other through entering into repurchase contracts collateralized against liquid and performing assets. The central bank could be a facilitator in the development of this interbank market; it could receive offers of and bids for surplus funds which it could allocate according to the demands, on rates to be freely determined by the market. In the case of regional monetary arrangements, such as in the CFA franc zone, regional interbank markets have been established. Similar regional interbank markets could also be explored among countries not belonging to the same monetary area, especially when parallel financial and prudential regulations are put in place and as the exchange markets are liberalized.

104. The linchpin of this development should be the liberalization of interest rates. This is best approached by the central bank introducing treasury bill auctions and/or central bank bill auctions. The market for treasury bills has to be nurtured through its various stages. Initially, the aim should be to

develop a primary market for the bills where commercial banks, and eventually other institutions and individuals, would bid for the offered amounts of bills. The auction process, to be credible, must be fully transparent, with clear and officially published rules. Treasury bills may be offered in smaller denominations and with varying maturities (three months to two years, for example), and non-bank investors should be encouraged to participate in the auction. These auctions must be held regularly, and at short intervals, to enable investors to plan their asset portfolio, and to establish the financing of treasury bill rates as the anchor for the structure of interest rates in the economy. The issue of treasury bills, while the prerogative of the Treasury or the Ministry of Finance, must nevertheless be done in consultation with the central bank and in the context of a monetary programming to be constantly updated at the central bank. To that effect, consideration should be given to the establishment of a joint central bank-Ministry of Finance monetary policy committee that would set and oversee monetary policy, while leaving its implementation to the central bank.

105. Central bank operations in treasury bills could eventually serve as an instrument of monetary management. For this purpose, proceeds from the treasury bill auctions should not be passed on automatically to the Treasury (credit to government, or net public sector borrowing should be decided in the context of the overall monetary programming). Instead, such proceeds should be held in a blocked Treasury account with the central bank which it could use to inject or withdraw liquidity in the economy. Thus, as a complement to the treasury bill auction sales, the central bank should introduce, at an appropriate stage, a mechanism of reverse repurchases ("repos") of treasury bills.

106. Once the primary market in treasury bills is operating smoothly, a stage would be set for the authorities to promote the secondary market in treasury bills where the banks would be willing to take an open position on treasury bills, perform market functions, and provide secondary trading facilities. The central bank should begin gradually to introduce treasury bills with longer maturities while ensuring their orderly pricing. Any subsidy element in directed lending should be scaled down and eliminated in a phased manner to avoid distortions in the interest rate structure. The requirement for a minimum liquidity ratio (usually in the form of cash and treasury bills) for deposit liabilities should also be phased out, as should any preferential tax treatment of interest earnings on all government securities.

107. The market in treasury bills should then be extended to deal in government securities in general, as a step towards entering into the third stage of financial intermediation. The strategy should be to develop a system of designated primary dealers whose principal purpose would be to provide adequate underwriting capacity to ensure an orderly primary distribution of the new issues of securities, and to be market makers in those securities, thereby imparting the needed liquidity. For this purpose, the central bank should promote the establishment, on a volunteer basis, of a critical mass of primary dealers who must satisfy certain minimum criteria (such as observing minimum capital standards) to possess the financial capacity to support the government securities market, and encourage competition. To ensure the safety, soundness and transparency of the system, as well as to ensure that dealers continue to maintain sufficient liquidity to meet their underwriting and market-making

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obligations, primary dealers should also be subjected to requirements governing the deployment of capital. The primary dealers should be allowed to conduct repurchase transactions, and have access to the call money market, as both lenders and as borrowers. The central bank would, of course, also provide a liquidity backstop to the primary dealers, as a last resort.

108. While treasury bills would be the basis on which to develop the short-term money market, the market should be expected gradually to extend its operations to include short-term trade bills, bank acceptances, negotiable certificates of deposits, and other short-term liabilities such as those of (reformed and restructured) state enterprises as well as private companies, especially as the banking system expands to include new entrants and other non-bank financial institutions emerge. A necessary institutional complement would be the establishment of discount houses which will deal initially in the treasury bills but will also gradually deal in non-governmental obligations. The successful experience of Ghana with the establishment of two discount houses - one owned jointly by commercial banks and insurance companies to serve as an interbank intermediary for short-term assets in the money market, and another established with International Finance Corporation (IFC) assistance to provide a secondary market for commercial paper - is an example worth following in other African countries.

109. Since the mid-1980s, African countries have begun to adopt diverse forms of market-determined exchange rate systems, including interbank and/or auction systems and foreign exchange bureaux. The broadening and deepening of financial markets along the lines indicated above should be further supported by the establishment of a competitive interbank exchange system that would allow financial intermediaries to continue to evolve market practices and instruments that would meet customers’ requirements. Such an interbank market should provide for active trading of foreign exchange between banks (and foreign exchange bureaux where they exist), with the central bank reducing its presence, in terms of buying and selling foreign exchange, in the market and limiting its activities to the management of official exchange reserves and undertaking foreign exchange transactions on behalf of the Government. It may, however, intervene in the market to smooth out unduly large fluctuations in the exchange rate, or in pursuance of specific predetermined monetary objectives. Further, the central bank should educate participants actively in the functioning of the foreign exchange markets, insist on receiving reports on dealers’ foreign exchange transactions, and improve the communication infrastructure that enables participants to receive relevant information, such as the rates being quoted by different dealers, with the minimum of delay. As in the case of the domestic interbank market, it is important that participants have confidence in each other’s capacity to settle their obligations.

110. The development of the third stage of financial intermediation would involve the establishment of a capital market, with its two distinct segments: the securities segment and the non-securities segment. While a proactive policy would appear to be appropriate to develop the money market end of the financial system in Africa, the development of the capital market would perhaps best evolve as a reflection of, and concomitant with, the economic development of individual African countries. This is particularly so as concerns the development of the securities segment of the market. At this stage, the role of

specialized development banks will diminish significantly as their functions are taken over by the capital market. The issuance of financial instruments such as stocks, bonds and debentures, and equity-related bonds will depend on the emergence of enterprises that would command enough public confidence to be trusted with their savings. On the institutional side, although institutions such as a stock exchange can be created formally, in the short and medium terms the creation of the stock exchange itself will not create a market in equities. An interrelated set of institutions, instruments, and fiscal, tax and legal issues must be resolved and be in place before the development of a successful stock exchange becomes possible. Stock exchanges, of course, do exist in some African countries such as Côte d’Ivoire, Ghana and Kenya, where some of the necessary institutions and instruments are available. However, they are yet to play their intended role actively; in Ghana, for example, market capitalization has been low: at the end of 1993, new issues constituted a minor part of the Exchange’s operations; only one out of 15 companies registered at that time on the Exchange offered a primary issue. In these countries the authorities are taking steps to encourage expansion of the activities of their stock exchanges through expanding membership, broadening the coverage of financial instruments to include trading in treasury bonds and other financial instruments, and promoting increasing floating of equity issues.

111. The strategy described above builds around four basic ingredients (liberalization of interest rate, removal of credit ceilings, changing the funding role of the central bank, and liberalization of foreign exchange), three policy instruments (treasury bill auctions, open market operations, foreign exchange auctions/interbank market in foreign exchange), and certain institution-building (restructuring of banks, prudential and supervisory framework, and establishment of institutions and mechanisms appropriate for the creation of the money and capital markets). African countries may wish to take these elements into account in formulating their policies to promote financial deepening and diversification.

VI. SUMMARY OF RECOMMENDATIONS

112. A number of African countries are implementing financial sector reforms aimed at reversing the earlier disintermediation of their financial systems and furthering financial deepening and diversification. However, financial systems are still among the weakest sectors in the African economies, and Governments should view the development of financial intermediation as top priority for policy makers.

113. Financial reforms in Africa so far have concentrated on the formal finance system, to the neglect of the informal system. The informal financial system mediates a significant amount of financial transactions and satisfies some of the financial needs in a flexible way, including for micro-finance, that would otherwise remain unmet. Encouragement and development of the informal system, drawing upon the traditional customs and practices, and fostering its linkages with the formal finance system should be an integral part of future efforts to further financial intermediation in Africa.

114. Financial reforms and macroeconomic stability are interdependent and mutually supportive, and must be synchronized and implemented simultaneously.

115. A gradual but proactive approach to developing financial markets is best suited to the circumstances of Africa. This would ensure that the necessary preconditions, such as the availability of an appropriate stock of human development capacity, are in place to support sustainable development of the financial system.

116. Financial sector development will be further facilitated if, inter alia, two basic ingredients of the market economy, the quality of governance and clarity in the delineation of property rights (that is, rules governing the ownership and transfer of assets), are in place.

117. Central banks have a crucial role to play in developing, nurturing and supervising the financial system, including the informal system. Accordingly, central banks should be kept fully equipped to perform their tasks as the monetary policemen of the economy. Restoring central banks in Africa to their primacy in financial management is crucial, and the core of human resources and skills should be directed towards improving their management and operational capabilities.

118. Policies to develop the informal system should begin with national efforts to seek to determine the overall magnitude of the operations and the role of the system. While leaving the purely informal system (comprising, for example, friends and relatives, moneylenders, traders and theoretically self-liquidating savings and credit associations (ROSCAS)) untouched, this initiative should cover institutions like the postal system, accumulating savings and credit groups like ASCRAS, credit unions and cooperatives, and NGO-sponsored credit institutions. Within this initiative:

(a) Postal savings systems should be reformed and developed into independent postal savings banks that offer attractive and competitive rates of return on deposits and invest their funds prudentially on a commercial basis. Combining credit with deposit functions could encourage savings and deposit mobilization. Further, where the commercial banking system is deficient or non-existent, postal savings banks can offer supplemental facilities to the informal sector for inter-institutional transfer of funds;

(b) Group savings institutions like ASCRAS, and credit unions and cooperatives, should be encouraged to form wider associations and be given name identity through licensing and registration with the central bank, where appropriate. They should also be encouraged to form closer linkages with the formal system through depositing and borrowing activities: the latter would be facilitated if these wider groupings were to develop legally enforceable "group liability" paper. Central banks can help this process by developing a common framework "Articles of association", including provisions relating to reserves, publication of accounts, etc. to which individual credit unions and cooperatives could subscribe voluntarily. As an inducement, central banks could provide them, free of cost, supervisory and regulatory services as well as on-the-job training, and conduct technical workshops and seminars for their personnel. The registration and regulation of these institutions should be multi-layered, ranging from self-regulation to formal regulation and supervision by the central bank;

(c) NGOs that are entering into the business of financial intermediation should also be covered by this policy initiative. To remain viable and to be able to on-lend on a revolving basis the funds provided to them, these institutions should also be licensed and required to produce, on a regular basis, a certain minimum amount of information regarding their operations. Further, they should be encouraged to move in the direction of deposit mobilization, as the provision of credit is often a strong motivation for savings;

(d) The international community can help African Governments in the development of specific rural-based deposit-mobilizing and micro-credit institutions through the provision of appropriate financial and technical assistance and other means, particularly drawing on the experience of successful cases of institution-building.

119. As concerns the formal financial system, its development would be accelerated on a sustainable basis if the countries were to pursue a three-pronged strategy aiming simultaneously at strengthening and promoting various bank and non-bank financial institutions, devising and promoting the development of a variety of financial paper, and developing and implementing indirect instruments to suit the specific circumstances of each country. Within this broad framework the following action may be needed:

(a) Restore failed and weak commercial banks and other financial institutions, accompanied by corresponding adjustments of the real sector, particularly of public enterprises;

(b) Adopt licensing and a prudential and supervisory regulatory framework that is neither so restrictive as to stifle competition nor so permissive as to attract shaky financial institutions. New entry of banks should be encouraged to promote competition. However, new banks must be licensed, requiring transparent and evenly applied criteria, in order to ensure the soundness of the system. In the interests of promoting regional integration and the emergence of wider financial markets in Africa, as well as to avoid costly "competitive" inducements to foreign entry, it is also desirable that countries adopt similar regulatory and prudential frameworks;

(c) Take measures to successively establish a clearing-house, set up an interbank market, create a primary market for treasury bills, followed by the development of a secondary market in those bills and by the extension of that market to private commercial and trade bills and long-term government securities;

(d) Liberalize interest rates as a necessary step towards the development of the financial markets, through the introduction of treasury bill auctions that are credible and transparent and attract wide participation;

(e) Develop treasury bill auctions to serve as an instrument of monetary policy, to which end proceeds from treasury bill sales should not be regarded as an indefinite source of financing government deficits but be held in a blocked Treasury account;

(f) Continue with the current efforts in many African countries to adopt market-oriented exchange systems, as full liberalization of foreign exchange will further assist financial deepening and attract foreign capital flows, including repatriation of earlier capital outflows;

(g) Encourage the establishment of institutions, such as stock exchanges, as building blocks to the development of capital markets, but expect that development to fructify only gradually and concomitantly with the economic development of the country and with the resolution of interrelated issues concerning institutions, instruments and fiscal and legal systems.

120. African countries will face problems of their own in their efforts to develop their financial systems, just as the Asian and Latin American countries did at the time they were undertaking financial reforms. Efforts should be made to apprise African Governments of the experience of those countries, especially how they overcame the obstacles they encountered. Among the problems encountered by these countries may be mentioned those related to unstable macroeconomic conditions, oligopolistic financial markets, and escalating high interest rates following financial liberalization. In response, the countries concerned made various flexible and pragmatic adjustments to the main elements of their reform programmes.

Notes

1/ International Monetary Fund, "Promoting economic development in Sub-Saharan Africa through sound macroeconomic and structural policies and the role of the IMF"; see also ibid., World Economic Outlook, May 1995 (Washington, D.C., 1995) which reviews the economic performance of Sub-Saharan Africa during the period 1986-1994.

2/ See Ababe Adera: "Instituting effective linkages between the formal and informal financial sectors in Africa: a proposal", Savings and Development, vol. XIX, No. 1, 1995.

3/ The term "informal sector" in this and the subsequent sections should be understood to include the semi-formal financial sector.

4/ In the interim, provisions may be made for "self-regulation" by members and shareholders themselves. Care should also be taken to avoid overburdening small informal operations with too many legal and reporting requirements. Bank supervision should be extended to informal sector entities only when the legal and physical infrastructure improves sufficiently to support effective supervision.

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Table 1. Matrix of institutions and instruments at various stages of intermediation

	Institutions	Policy instruments	Financial instrument
I. Primary stage	1. Central bank	Credit ceilings, controlled interest rate, discounts, statutory reserve requirements, directed credit	Currency, treasury bills
	2. Commercial banks		Demand, time and savings deposits, loans and advances (mainly short-term)
	3. Development banks		Loans and advances (short-, medium-, and long-term) equity participation
	4. Semi-formal institutions, post office savings banks, credit unions, ASCRAS and others		Deposits, loans (consumer credit and micro-enterprises)
	5. Informal institutions, ROSCAS, money-keepers, moneylenders, etc.		Deposits, loans (short-term, mainly consumer credit)
II. Intermediate stage	1. Central bank	Partial liberalization of interest rates, credit ceilings, liquidity or reserve ratios, treasury bill auctions, "repos.", foreign exchange bureaux	Currency, treasury bills and bonds/central bank bills
	2. Commercial banks	Participants in treasury bill auctions, deposit guarantee schemes, clearing-house	Deposits, loans and advances of various maturities, certificates of deposit, commercial paper interbank (overnight) loans and deposits
	3. Development banks		Bond issue, loans and advances and equity participation in private and public enterprises
	4. Non-bank financial institutions, discount houses, merchant banks, insurance companies, pension funds, unit trusts and venture-capital companies	Participants in treasury bill auctions, commercial trade paper, loans (medium- and long-term), equity participation	Deposits, shares, insurance policies

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	Institutions	Policy instruments	Financial instrument
	5. Semi-formal institutions, post office savings banks, credit unions, ASCRAS and others		Group guarantees, deposits and loans
	6. Informal institutions, ROSCAS, moneykeepers, moneylenders and traders		Deposits, loans (short-term and mainly consumer credit)
III. Advanced stage	1. Central bank	Full interest rate liberalization, monetary programming, often market operations, reserve ratios, demand-based rediscounts, full liberalization of exchange	Treasury bills, government securities, central bank paper
	2. Commercial banks	Participants in both the primary and secondary markets for short- and long-term securities	
	3. Non-bank financial institutions	Participants in the stock exchange, as well as in the treasury bill and government securities market	Private sector bonds and equities
	4. Semi-formal institutions	As in the intermediate stage, but perhaps reduced importance of the informal sector and graduation of some semi-formal institutions into formal ones	
	5. Informal institutions		

Table 2. Africa: measures of financial deepening

	M2/GDP	M1/GDP	C/GDP	DD/M2	⌂M2/Saving
Primary stage					
Benin	0.28	0.22	0.31	0.45	3.2
Burkina Faso	...	...	0.62	0.27	0.34
Burundi	0.18	0.12	...	...	...
Central African Republic	0.16	0.14	0.89	0.16	16.49
Chad	0.18	0.17	0.77	0.25	-0.52
Congo	0.22	0.16	0.53	0.34	0.91
Equatorial Guinea	0.07	0.06	0.43	0.46	0.14
Gabon	0.15	0.09	0.39	0.37	0.22
Guinea	...	...	...	...	...
Guinea Bissau	0.15	0.19	0.66	0.23	...
Madagascar	0.23	0.16	0.35	0.46	3.27
Mali	0.22	0.16	0.56	0.31	0.27
Mauritania	0.27	0.21	0.41	0.43	...
Mozambique	0.12	0.08	...	...	...
Niger	0.20	0.11	0.58	0.30	1.13
Sierra Leone	0.15	0.10	0.60	0.27	0.65
Sudan	0.28	0.23	...	...	...
Togo	...	...	0.32	0.26	1.63
Uganda	0.80	0.06	0.48	...	...
Zaire	0.16	0.14	0.60	...	...
Intermediary stage					
Algeria	0.59	0.41	0.20	0.30	0.36
Botswana	0.31	0.10	0.27	...	...
Cameroon	0.21	0.14	0.46	0.31	0.29
Cape Verde	0.47	0.29	0.32	0.40	-3.12
Côte d'Ivoire	0.31	0.17	0.54	0.29	...
Djibouti	0.79	0.36	0.30	0.39	...

	M2/GDP	M1/GDP	C/GDP	DD/M2	⌂M2/Saving
Ethiopia	0.64	0.44	0.65	0.25	-17.06
Gambia	0.22	0.13	0.48	0.32	-2.22
Ghana	0.17	0.12	0.49	0.35	2.22
Kenya	0.72	...	0.37	0.21	0.51
Lesotho	0.35	0.17	0.11	0.41	-0.07
Malawi	0.22	0.11	0.40	0.29	1.34
Morocco	0.60	0.45	0.15	0.50	0.27
Namibia	0.37	0.18	...	...	...
Nigeria	0.27	0.15	0.38	0.31	0.36
Senegal	0.23	0.16	0.48	0.30	0.12
Seychelles	0.41	0.13	0.41	0.17	0.34
Swaziland	0.32	0.09	0.24	0.21	0.25
Tunisia	0.46	0.20	0.08	0.25	0.47
United Republic of Tanzania	0.41	0.28	0.51	0.32	0.10
Zambia	0.22	0.10	...	0.28	0.18
Zimbabwe	1.02	...	0.24	0.22	0.50
Advanced stage					
Egypt	0.80	0.22	0.11	0.10	0.80
Mauritius	0.74	0.13	0.55	0.11	0.47
South Africa	0.75	...	...	...	1.12

Source: *International Monetary Fund International Financial Statistics*, various issues.

C = Currency, DD = Demand deposits
M1 = Currency + Demand deposits
M2 = M1 + Time deposits, ⌂M2 = Changes in M2
For supplementary information relating to institutions and instruments, see table 1.
