

# SUB-SAHARAN AFRICA FINANCIAL SECTOR CHALLENGES

Anne-Marie Gulde, Catherine Pattillo, and Jakob Christensen  
with Kevin Carey and Smita Wagh

International Monetary Fund

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Production: IMF Multimedia Services Division  
Cover design: Luisa Menjivar and Massoud Etemadi  
Typesetting: Alicia Etchebarne-Bourdin

**Cataloging-in-Publication Data**

Sub-Saharan Africa: financial sector challenges/Ane-Marie Gulde, Catherine Pattillo, and Jakob Christensen, with Kevin Carey and Smita Wagh—[Washington, D.C.]: International Monetary Fund, c2006.

p. cm.

ISBN 1-58906-565-4

Includes bibliographical references.

1. Finance—Africa, Sub-Saharan. 2. Financial institutions—Africa, Sub-Saharan. 3. Financial services industry—Africa, Sub-Saharan. 4. Monetary policy—Africa, Sub-Saharan. I. Pattillo, Catherine A. (Catherine Anne). II. Christensen, Jakob. III. International Monetary Fund.

HG187.5A357G85 2006

Price: US\$19.00

Please send orders to:

International Monetary Fund, Publication Services  
700 19th Street, N.W., Washington, D.C. 20431, USA  
Tel.: (202) 623-7430 • Telefax: (202) 623-7201  
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The following conventions are used in this publication:

- In tables, a blank cell indicates “not applicable,” ellipsis points (. . .) indicate “not available,” and 0 or 0.0 indicates “zero” or “negligible.” Minor discrepancies between sums of constituent figures and totals are due to rounding.
- An en dash (–) between years or months (for example, 2005–06 or January–June) indicates the years or months covered, including the beginning and ending years or months; a slash or virgule (/) between years or months (for example, 2006/06) indicates a fiscal or financial year, as does the abbreviation FY (for example, FY2006).
- “Billion” means a thousand million; “trillion” means a thousand billion.
- “Basis points” refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percentage point).

As used in this publication, the term “country” does not in all cases refer to territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

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# Preface

Building efficient and sound financial sectors in sub-Saharan Africa (SSA) is vital for poverty reduction and growth. This book discusses the main obstacles and challenges that financial structures pose for SSA economies, and the financial reform agenda. An earlier, shorter version of this book's material appeared in the May 2006 issue of the *Regional Economic Outlook: Sub-Saharan Africa*, which was prepared in the Policy Wing of the IMF's African Department under the direction of Benedicte Vibe Christensen, Deputy Director. Dmitry Gershenson, Amadou Sy, Charles Yartey, and Behrouz Guerami made substantial contributions to the book. Gustavo Ramirez provided research assistance, Anne Grant provided editorial assistance, and Suresh Gulati and Ena Baldwin were responsible for document production. In the IMF's External Relations Department, Archana Kumar edited the manuscript and James McEuen coordinated production of the publication.

The book benefited from comments from staff in the African Department and other departments of the IMF. The authors would like to thank their colleagues in the IMF, World Bank, and academia for useful discussions on financial sector issues, and for sharing data. Opinions expressed in the book are those of the authors and do not necessarily represent the views of the IMF, its Executive Directors, or the authorities of the countries covered in the study.



# Introduction

**F**inancial sectors in low-income sub-Saharan Africa (SSA) are among the world's least developed (see Appendix 3, Table A1). The range of institutions is narrow, and assets in most low-income African countries are smaller than those held by a single medium-sized bank in an advanced economy. Most people do not have access to even basic payment services or savings accounts, and the largest part of the productive sector cannot obtain credit. Some middle-income African countries perform notably better, however.

The absence of deep, efficient financial markets constrains economic growth. Limited access to finance lowers welfare and hinders poverty alleviation and the emergence of an economically active middle class. Finally, implementing monetary policy in the context of shallow markets is costly and inefficient.

Financial development increases economic growth through a number of channels. Finance mobilizes and pools savings; produces information on possible investments so that resources can be channeled to their most productive use; monitors the use of funds; facilitates the trading, diversification, and management of risk; and eases the exchange of goods and services (Levine, 1997, 2004). Empirical studies confirm that countries with better-functioning financial systems grow faster, and that the result does not seem to be driven by reverse causality. The link between finance and growth operates importantly through overcoming external financing constraints that otherwise hinder firm expansion. Among SSA countries other

than oil producers, the most financially developed economies grew the fastest between 1960 and 2004 (Appendix 3, Figure A1). Because it is a high-risk environment, exposed to terms-of-trade shocks and a volatile climate, SSA would benefit from financial development facilitating greater risk sharing through portfolio diversification, consumption smoothing, and insurance. Finally, access to formal financial institutions could help surmount inefficient and costly strategies for coping with risk and obtaining capital (Collier and Gunning, 1999).

Financial development also helps reduce poverty. Theory suggests that financial development reduces credit constraints on the poor—for whom financial market imperfections are particularly binding (Galor and Zeira, 1993). The mechanisms are wide-ranging: from alleviating credit constraints, so that households can invest in education, to insuring against shocks. Finance can also allow small firms and individuals to make use of new growth opportunities that arise when markets open.

This book argues that deeper and more efficient financial markets will improve Africa's economic prospects. Based on a review of the key features of financial systems, it discusses the main obstacles and challenges that financial structures pose for African economies. It then reviews ongoing reform efforts, and the extent to which they have already set in motion changes for the better. Recognizing that a vast reform agenda remains, the book concludes by discussing steps that could address major shortcomings.



## Key Characteristics

### Institutional Coverage and Ownership

*Institutional coverage is limited, with a strong dominance of the banking system. Most banking systems in Africa are open to foreign entry, and foreign banks have a large market share.*

Financial sectors in low-income sub-Saharan Africa are small. Banks are the dominant institutions. The size of about half of the SSA countries' financial systems, measured in terms of M2, is less than \$1 billion, not much larger than a small bank in an industrial country.<sup>1</sup> Insurance sectors are very small relative to the size of economies and population. While the nonbank financial intermediary (NBFI) and microfinance sectors are growing, the latter quite rapidly, penetration is still relatively low. In most of SSA, banking sectors still cover more than 80 percent of the assets of the financial system, though the few middle-income countries have larger financial sectors and a broader institutional coverage (see Box 1 on financial market development in middle-income SSA countries).<sup>2</sup>

SSA banking systems have higher shares of foreign ownership, while state banks are less important than

in other low-income countries (LICs; see Table 1). Foreign ownership increased sharply between 1996–99 and 2000–03; and particularly large increases occurred in middle-income countries and those with IMF-supported programs.<sup>3</sup> The converse movements in state and foreign ownership reflect a common pattern of restructuring in which state-owned banks were sold to foreign banking companies. Several countries, however, including Ethiopia, still have significant state banks, and limited access by foreign banks.

There are indications that the NBFI sector is growing in importance in SSA. At present, the sector remains small compared with the banking sector in almost all countries, with the asset size of insurance companies, pension funds, and other NBFIs accounting for less than 10 percent of the total financial system assets (see Appendix 3, Table A2).<sup>4</sup> But there are notable exceptions. As a share of total

<sup>1</sup>Except for South Africa, Nigeria, and Kenya, the combined financial size of the the remaining countries is below \$6 billion.

<sup>2</sup>This section draws on a wide variety of data sources, including recent country-level Financial Sector Profiles prepared by the IMF's African Department. Country-level studies of financial markets conducted in the IMF's African Department were also used (Uganda: Peiris, 2005; Botswana: Kim, 2004; Lesotho: Gershenson, 2004; and Kenya: Powell, 2003).

<sup>3</sup>Table 1 uses Bankscope country-level aggregate data, while the other banking sector tables are calculated from Bankscope bank-level data. The primary data source for Bankscope is the Fitch ratings database, which rates banks as actual or prospective borrowers from capital markets. Bankscope covers a sample of banks in each country. For SSA, 34 countries are covered, and within these countries, 381 banks compared with the 453 that were counted in the IMF African Department's Financial Sector Profiles (2005). Because the unit of observation in the bank-level data is the bank, bank-level data are in effect weighted toward countries with more banks.

<sup>4</sup>Data from the IMF's Financial Sector Assessment Programs (FSAPs) in SSA indicate that life insurance penetration indicators, measured by premiums/GDP, are very low in SSA—at 1–2 percent of GDP (except in South Africa). This is based on data from 1997 to 2002.

### Box I. Financial Development in Middle-Income Sub-Saharan African Countries

On average, financial sectors in the few SSA middle-income countries are significantly deeper, sounder, and more diversified than in the majority of African countries. While this report concentrates on low-income countries (LICs), the successes of middle-income African countries are noteworthy. Their relatively good performance is only in part explained by higher income. At the same time, the middle-income oil economies face many of the same challenges as LICs.

SSA's middle-income countries have much larger financial sectors and broader institutional coverage. Key financial depth indicators in middle-income SSA<sup>1</sup> are comparable to or higher than in other middle-income

countries (see the first table), though this is to some extent driven by South Africa's far more mature financial sector. While financial depth ratios in middle-income SSA countries other than South Africa are still substantially higher than in low-income SSA countries, they are lower than in middle-income countries in other developing regions. On private sector credit, South Africa's ratio, at almost 80 percent to GDP, is among the highest in the developing world, and Botswana, Mauritius, and Namibia also compare favorably with other developing regions. Institutional coverage—in particular, the insurance and pension sectors—tends to be much broader in the southern African middle-income countries and Mauritius.

More sizable financial sectors in middle-income SSA countries have given their populations greater access to financial services. Branch density is approximately 10 times higher in middle-income than in low-income SSA countries (see the second table).

<sup>1</sup>Based on World Bank classification, SSA middle-income countries are Angola, Botswana, Cape Verde, Equatorial Guinea, Gabon, Mauritius, Namibia, Seychelles, South Africa, and Swaziland.

#### Indicators of Financial Development by Income Group

	Sub-Saharan Africa							
	Low-income countries		Middle-income countries		Middle-income countries without South Africa		Other Middle-Income Countries	
	1990–99	2000–04	1990–99	2000–04	1990–99	2000–04	1990–99	2000–04
Bank deposits/GDP	13.6	18.0	44.5	50.7	29.7	29.2	31.7	39.4
Private sector credit/GDP	12.3	13.3	52.1	64.0	21.5	21.0	39.4	40.3
M2/GDP	21.9	26.9	49.8	55.6	35.0	32.1	77.3	94.2
Liquid liabilities/GDP	19.1	23.8	47.9	53.4	34.5	32.5	36.6	41.2

Source: IMF, *International Financial Statistics*.

Note: The average weight of South Africa among middle-income countries over the 2000–04 period is 84.5 percent.

#### Access, Soundness, and Efficiency Indicators by Income Group, 2004

	Access			Soundness		Efficiency		
	Population with formal bank account	Branch network per 100,000 inhabitants	Branch network per 1,000 sq. km.	Capital adequacy ratio (percent of risk-weighted assets)	Non-performing loans (percent of total loans)	Interest margin (percent of assets)	Overhead (percent of assets)	Profits (percent of assets)
Sub-Saharan Africa	12.6	2.6	4.3	15.5	14.7	8.2	7.4	3.0
Low-income countries	7.0	1.2	1.1	15.7	17.5	8.5	7.7	3.2
Middle-income countries	25.3	5.6	11.4	16.5	6.8	6.7	6.4	2.3
without South Africa	21.9	5.6	12.4	16.9	7.5	6.6	5.2	3.5

Sources: Beck, Demirguc-Kunt, and Peria (2005); IMF, *Financial Sector Profiles*; Claessens (2005); and calculations from IDB bank-level data.

Note: The efficiency indicators are the averages for 2000–03.

**Box I (concluded)**

The proportion of the population with bank accounts is also higher: Botswana and South Africa have the highest access in the region; almost half of the population have accounts.

Banking sectors in middle-income SSA countries have lower costs and are more efficient; moreover, they exhibit stronger financial soundness indicators. Specifically, they have substantially lower overhead costs and lower net interest margins—indicating higher efficiency—compared with both low-income SSA countries, and other lower-middle-income countries. On soundness, at 6.8 percent in 2004, nonperforming loans as a percent of total loans were substantially lower than in low-income SSA countries (17.5

percent). By 2004 capital adequacy and liquidity ratios were comparable between the two groups, reflecting recent improvement in the low-income group.

Banking in oil producers, Angola, Gabon, and Equatorial Guinea, is different from banking in the other middle-income countries. Lending to the private sector is very limited, and branch network density and access are even lower than in most low-income SSA countries. The number of banks in these countries is low relative to the size of the economy, reflecting limited lending opportunities in the non-oil economy. Challenges in these countries are therefore similar to those discussed in the rest of this book.

TABLE I

**Sub-Saharan Africa and Comparator Groups: Ownership in the Banking Sector***(Share of bank assets)*

	State Ownership		Foreign Ownership	
	1996–99	2000–03	1996–99	2000–03
Sub-Saharan Africa	0.2	0.1	0.4	0.5
Other low-middle-income	0.3	0.3	0.2	0.2
Sub-Saharan Africa low-income	0.3	0.2	0.4	0.4
Other low-income	0.4	0.4	0.1	0.1
CFA countries	0.1	0.1	0.5	0.5
Oil producers	0.1	0.2	0.3	0.3
Sub-Saharan Africa middle-income	0.2	0.1	0.4	0.6

Source: IDB country-level data.

Note: The income groupings are based on the World Bank rankings of gross national income (GNI) per capita in 2004. The groups are: low-income, GNI per capita of \$825 or less; lower-middle-income, GNI per capita of \$826–\$3,255. “Low-middle-income” refers to countries in these two groups; low-income refers to the former only.

financial system assets, the insurance sector is particularly large in Kenya and Gabon, pension funds in Rwanda and Botswana, and other NBFIs in Botswana and Zambia.

**Soundness and Efficiency**

*Based on standard indicators, most banking systems are on average reasonably sound and adequately capitalized. However, there are indications that standard indicators may not fully capture the risks to which banking systems are exposed. Also, while banking systems are profitable, they are less efficient than elsewhere in the world.*

**Banking Sector Soundness**

The overall soundness of banking systems in SSA is now generally stronger than in the 1990s, when the continent experienced a number of banking crises. The share of nonperforming loans (NPLs) in total loans was over 30 percent in the early 1990s but has fallen since then in most countries as a result of resolution measures, improved macroeconomic conditions in the region, and reduced government interference with lending decisions (Fofack, 2005). Bank-level data indicate that SSA banks now exhibit levels of basic soundness similar to those of banks in other low-income countries (Table 2 and Appendix 4, Table A4). The decline in provisioning rates may

TABLE 2  
**Sub-Saharan Africa: Financial Soundness Indicators**  
*(Percent of assets)*

		Sub-Saharan Africa	Other Low-Middle-Income (excluding SSA)	Sub-Saharan Africa Low-Income	Other Low-Income (excluding SSA)
Total problem loans	1996–99	9.2	8.5	9.4	9.1
	2000–03	8.3	15.6	9.1	9.4
Total capital	1996–99	14.5	14.1	15.6	13.8
	2000–03	18.9	17.1	21.4	15.7
Liquid assets	1996–99	26.3	20.0	30.5	21.2
	2000–03	28.8	21.2	28.8	21.9
Provisioning (percent of problem loans)	1996–99	44.4	65.5	74.8	40.4
	2000–03	43.9	39.3	41.3	29.6

Source: IMF staff calculations from bank-level data by IDB staff.

reflect the extensive efforts at balance sheet cleanup in the 1990s. As part of the resolution of the banking crises, many countries implemented bank organizational and financial restructurings, often followed by privatization. The implementation process was, however, often weak, sometimes requiring multiple restructurings. In the process, the financial system's ability to perform its core functions suffered.

On average, banking sectors are adequately capitalized and liquid. Most countries have implemented an 8 percent minimum risk-weighted capital adequacy ratio (CAR), and actual rates for most systems exceed this minimum. For SSA as a whole, CARs are around 16 percent. Liquidity ratios (the ratio of liquid assets to liquid liabilities) are in the range of 30 to 40 percent, which far exceeds levels seen elsewhere (Appendix 4, Figure A3). In any country, individual banks can fall sufficiently below the average and thus fail to meet the basic adequacy test. Although such violations do not affect the soundness of the system as a whole, they indicate persistent problems in implementing banking supervision.

Financial soundness, however, differs widely among SSA countries, and important weaknesses persist. Average NPLs in 2004 stood at 15 percent, but figures ranged from as high as 32 percent for Burundi in 2004 to very small numbers observed for South Africa (and other rand zone countries) in both periods.<sup>5</sup> The

<sup>5</sup>Given differences in definition, NPLs may not be fully comparable across countries. The definition of NPLs is more stringent than "problem loans" (strictly based on the timing of overdue payments) reported in Table 2. These also take expected ability to repay into account.

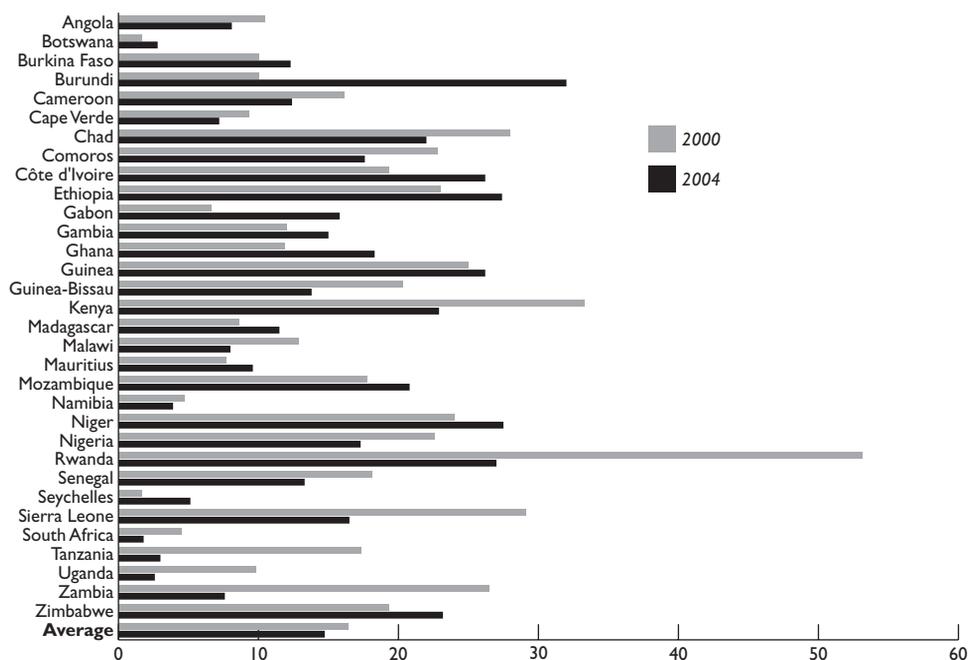
higher-income countries seem to have lower NPLs. NPLs in other countries seem to reflect a variety of factors, including ongoing or past conflicts, remaining government involvement, or a legacy of past problems, including insider lending and poor bank governance. CFA countries are generally clustered in the medium NPL group (Figure 1).<sup>6</sup> Liquidity ratios in low-income SSA countries are significantly higher than in other low-income countries. Provision rates (as a percentage of problem loans) have declined between the late 1990s and 2000–03.

Financial soundness indicators may not always be a sufficient yardstick for assessing outcomes for SSA. Less diversified low-income countries have been found to exhibit greater credit risk and should ideally have higher CARs to reflect this operating environment (Narain, Rabanal, and Byskov, 2003). Yet few African countries set minimum CARs above 8 percent. Data on underlying risks—in particular on issues such as the sectoral distribution of loans—are less frequently collected than in other regions.<sup>7</sup> Other prudential ratios, such as those limiting single client or sectoral exposures, are frequently violated because African economies do not offer a sufficiently large pool of lending opportunities. Finally, on liquidity,

<sup>6</sup>Trends in NPLs can be difficult to interpret, since a rising NPL trend may reflect better reporting mechanisms or tighter supervisory requirements. Large client exposure can make NPLs volatile from year to year. In addition, provisioning mechanisms may differ across countries, and the underlying collateral (if any) for NPLs will be a major determinant of their final impact on bank balance sheets.

<sup>7</sup>Based on Slack (2003), who surveys collection and dissemination of financial soundness indicators in 100 countries.

FIGURE I

**Sub-Saharan Africa: Nonperforming Loans in 2000 and 2004***(Percent of total loans)*

Source: IMF, Financial Sector Profiles.

Note: When data were not available for the indicated year, the closest available year was used.

prudential indicators are set to ensure that banks are able to meet withdrawal demands at short notice. Yet, with actual ratios many times exceeding prudential minimums, liquidity ratios need to be interpreted not only with prudential concerns in mind but also with a view to factors impeding a more efficient use of liquidity.

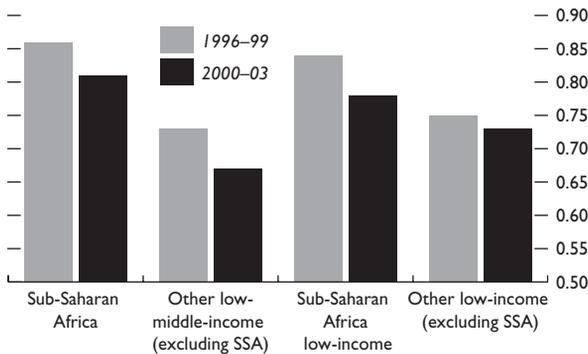
### Efficiency and Profitability

Efficient banks are important for financial market development, but systems in most African countries remain highly concentrated and have high operating costs. Literature suggests that banking market structure is important both for banks' financial standing and for the provision of financial services, including access to loans: increased competition leads to higher bank efficiency and improved access (Demirguc-Kunt, Laeven, and Levine, 2004; Barth, Caprio, and Levine, 2004; and Beck, Demirguc-Kunt, and Maksimovic, 2004). Indicators of banking market efficiency include competition and operational efficiency. In

addition to market structure, banking sector efficiency will also be influenced by macroeconomic factors, regulations, and institutions.

Banking sectors in SSA have higher concentration ratios than in other low-income countries, although these ratios are falling. This measure of the share of banking assets held by the three largest banks is about one-tenth higher for SSA than for other LICs (Figure 2). Among different explanations, the small market size is seen as a major factor contributing to concentration, given the need for institutions to reach economies of scale and scope (Bossone, Honohan, and Long, 2002). For SSA, while the number of competitors in a banking market is positively associated with population and economy size, there are a number of outliers in this relationship (Figure 3). Following continued bank restructuring and privatization, average SSA concentration ratios declined in 2000–03 from levels in 1996–99. Concentration ratios, however, do not provide a full picture of the competitive environment; the overall number of banks and entry restrictions are also important for the contestabil-

**FIGURE 2**  
**Sub-Saharan Africa and Comparator Groups:**  
**Banking Sector Concentration Ratios**



Source: World Bank, Financial Structure database.

Note: The income groupings are based on the World Bank rankings of gross national income (GNI) per capita in 2004. The groups are: low-income, GNI per capita of \$825 or less; lower-middle-income, GNI per capita of \$826–\$3,255. “Low-middle-income” refers to countries in these two groups; low-income refers to the former only. Sub-Saharan Africa has a small number of upper-middle-income countries (GNI per capita between \$3,256 and \$10,065), namely Botswana, Equatorial Guinea, Gabon, Mauritius, Seychelles, and South Africa. However, no upper-middle-income countries outside SSA are used in the comparisons.

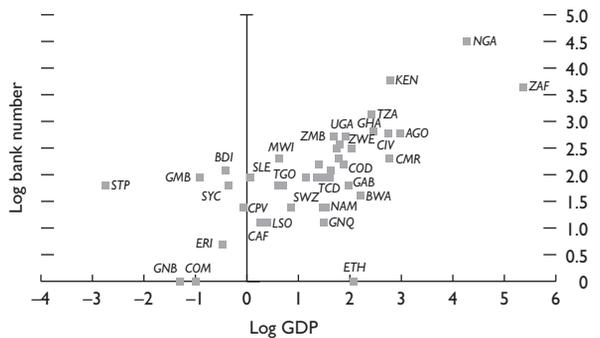
ity of markets.<sup>8</sup> Since 2000, the share of foreign ownership has increased, indicating some market contestability (Micco, Panizza, and Yanez, 2004).

Banking sectors in low-income SSA are less efficient than global comparators. The ratio of overhead costs to total assets and the net interest margin are common measures of banks’ operational efficiency.<sup>9</sup> Both banking system aggregate and bank-level data show that overhead costs and net interest margins are higher in low-income SSA than in other LICs, and the gap has widened in the most recent period (Appendix 4, Table A5). Efficiency indicators are similar across ownership groups, with foreign banks—contrary to expectations—not mea-

<sup>8</sup>Banking entry or activity restrictions cannot fully account for highly concentrated banking systems in SSA. While there is no clear difference between SSA and comparator groups on most of these restriction measures, the share of entry applications denied is somewhat higher in SSA (Barth, Caprio, and Levine, 2006).

<sup>9</sup>The interest margin measures the difference between interest earned on assets and interest paid on liabilities. More efficient banking systems will be able to have lower interest margins. Banks with high operating costs must earn high interest income to cover these costs, which is why it is used as a measure of inefficiency. However, the margin could also be high because of monopolistic profits or low because of risk aversion or interest rate controls, so it is not solely a measure of sectoral efficiency.

**FIGURE 3**  
**Sub-Saharan Africa: Size of Economy**  
**and Number of Banks**



Sources: IMF, Financial Sector Profiles; and World Economic Outlook.

surably more cost efficient. Cross-country regressions following recent research finds that banking market efficiency is negatively correlated with inflation, corruption, and concentration (Appendix 4, Table A6; Detragiache, Gupta, and Tressel, 2005). Even accounting for these factors, a dummy variable for SSA countries remains significant, indicating that operational efficiency of banking in SSA is lower than predicted by the model.

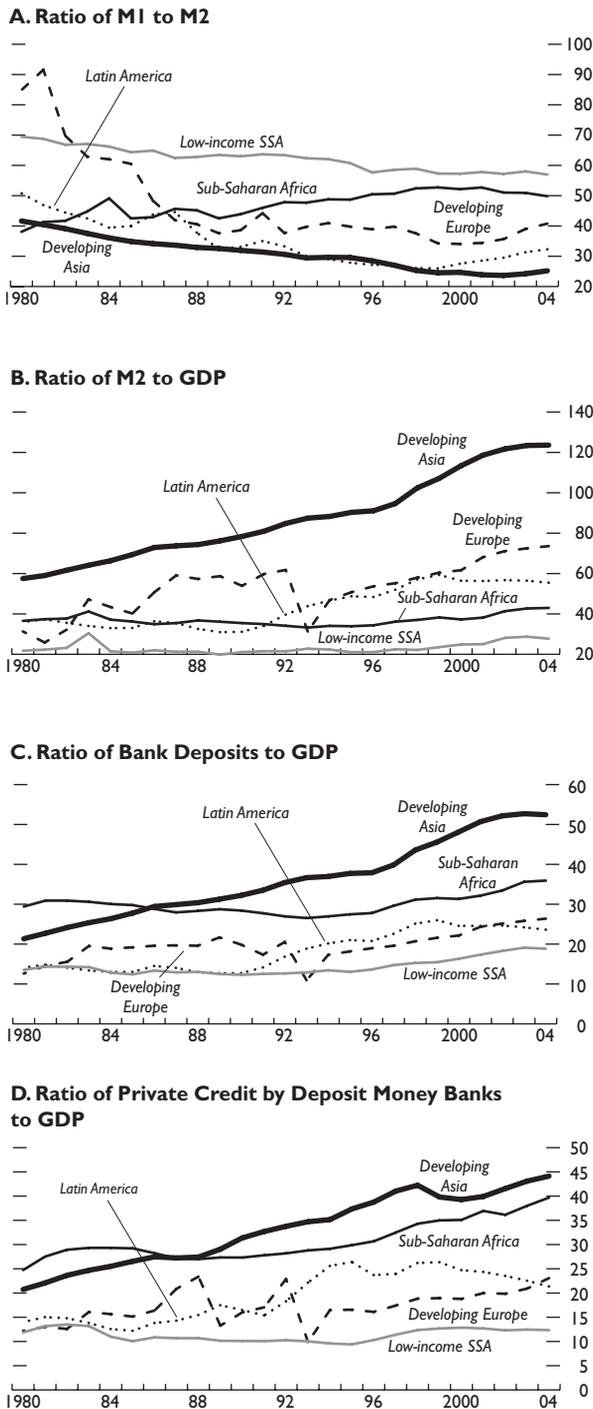
Despite high overhead costs, SSA banks are profitable. SSA banks’ main income sources are interest-related income, and interest rate margins are higher than in other LICs. Therefore, despite higher overhead costs and similar levels of loan loss provisioning as in other LICs, overall profitability exceeds levels in other LICs. Increases in net interest revenue also largely account for an increase in bank profitability in low-income SSA from the 1996–99 to the 2000–03 period.

## Markets, Instruments, and Market Infrastructure

*There are few functioning financial markets. As a result, banks play a limited role in the economy, and cash remains the dominant financial instrument. Interbank activity is constrained, and efforts to enhance financial market infrastructures have not yet had visible effects on financial market deepening.*

Given the importance of cash, financial depth indicators in low-income SSA are the lowest in the world. The ratios of narrow (M1) and broad (M2) money to

FIGURE 4  
**Sub-Saharan Africa and Comparator Groups:  
 Financial Depth Indicators**  
 (Percent)



Sources: IMF, *International Financial Statistics*; and *World Economic Outlook*.

GDP are common indicators of financial depth. As financial markets deepen, the expectation would be for broad money to grow faster than narrow money, with a corresponding decline in the ratio of M1 to M2. In low-income SSA countries, these financial depth measures have always been low. Since the 1990s, however, the M1 ratio has been increasing faster than M2 (Figure 4, first two panels), with Africa now having the highest M1-to-M2 ratio even among LICs, reflecting that other regions have made faster progress in moving to noncash means of payment.

The financial intermediation role of banks is less pronounced than in other LICs. Bank deposits were only 19 percent of GDP in low-income SSA in 2004, compared with 38 percent in other developing regions (Figure 4, third panel). Similarly, private sector loans were only 13 percent of GDP in 2004, reflecting sluggish growth in lending over the past decades (Figure 4, fourth panel). While reasons for the slow growth of banking activities are manifold, there are indications that they are—in part—related to the aftereffects of banking crises, as well as to the weakness in legal and institutional frameworks (see the section on legal environment and business practices, below). Private sector deposits and credit in the CFA countries have remained stagnant after the sharp contraction experienced following the regionwide banking crises in the late 1980s (see Box 2 on long-term effects of banking crises).

Minimal interbank activity is a sign of immature financial markets. In more advanced countries, the bulk of financial sector activities takes place among financial institutions. Such trades help market efficiency and trading of risk, and deepening interbank markets are signs of maturing financial systems. Interbank data are not systematically collected by all African countries, but evidence from interbank money market data in the West African Economic and Monetary Union (WAEMU) and the Central African Economic and Monetary Community (CEMAC) indicates stagnating or a very slow recovery following earlier declines (Appendix 3, Table A3). The absence of functioning interbank markets reflects not only a combination of macroeconomic factors, including the high level of liquidity, but also a lack of collateral and other obstacles. In the absence of supporting changes, significant technical assistance efforts in the area of interbank market development have yet to lead to tangible results.

Reflecting a lack of demand, efforts to promote better financial market infrastructure have not been fully successful in increasing market activities. Many

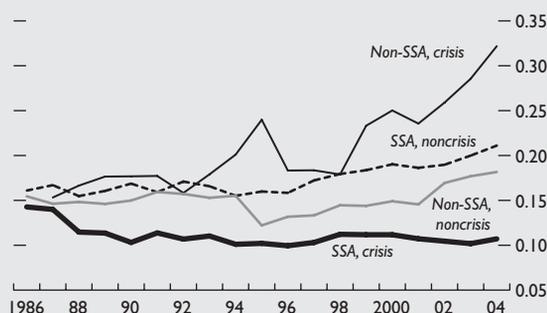
## Box 2. The Long-Term Costs of Banking Crises: Lessons from Sub-Saharan African Countries

A large number of African countries experienced systemic banking crises in the late 1980s and early 1990s. In most cases, these crises were preceded by a significant deterioration in asset quality relating to either worsening macroeconomic environments or inadequate lending procedures and application of prudential regulations.

Subsequent bank restructuring and recapitalization entailed significant fiscal costs. Authorities injected new capital into banks and cleaned up the balance sheets through the issuance of restructuring bonds. The associated fiscal costs of these operations have been estimated at about 11 to 16 percent of GDP. In addition, many loss-making public banks were privatized (Cape Verde, Democratic Republic of the Congo, Uganda) or closed (Rwanda). The strengthening of the banking sector and stricter application of prudential regulations have been followed by a fall in the ratio of nonperforming loans to total loans in crisis countries to the level in noncrisis countries (see the table).

In addition, banking crises have had persistent negative effects on financial depth. While noncrisis countries have seen an increase in financial intermediation over the past decade, improvements have been only marginal in crisis countries, reflecting weak public confidence in banks and unwillingness of banks to extend credit to the private sector. As a result, banking systems in crisis countries have much

### Financial Crises and Bank Lending to the Private Sector (Percent of GDP)



Source: IMF, *International Financial Statistics*.

lower ratios of domestic claims, quasi-money, and deposits to GDP and a much higher share of net foreign assets relative to domestic loans than banks in noncrisis countries.

The pattern of persistently low depth in SSA crisis countries is difficult to reconcile with the experience elsewhere. In developing countries, the impact of banking crises on financial depth tends to dissipate quickly (Caprio and Honohan, 2005). Three possible sources of banking crises can be distinguished: collapse of unsustainable macroeconomic policies, state-directed lending into poor quality projects, and

### Sub-Saharan Africa: Bank Portfolios and Financial Depth in Crisis and Noncrisis Countries

	Reserves (share of deposits)	Foreign Assets (share of domestic loans)	Quasi-Money (share of GDP)	Deposits (share of GDP)	Claims on Government (share of GDP)	Claims on Private Sector (share of GDP)
<b>1985–89</b>						
Noncrisis	0.25	0.13	0.12	0.19	0.05	0.15
Crisis	0.23	0.16	0.10	0.16	0.03	0.14
<b>1990–94</b>						
Noncrisis	0.21	0.24	0.12	0.19	0.05	0.14
Crisis	0.22	0.30	0.10	0.16	0.02	0.13
<b>1995–99</b>						
Noncrisis	0.15	0.29	0.14	0.22	0.06	0.16
Crisis	0.16	0.43	0.10	0.17	0.04	0.12
<b>2000–04</b>						
Noncrisis	0.15	0.32	0.16	0.26	0.08	0.19
Crisis	0.18	0.49	0.10	0.18	0.05	0.11

Source: IMF, *International Financial Statistics*.

Note: Countries that had a large banking crisis in the 1990s are Benin, Cameroon, Cape Verde, Central African Republic, Côte d'Ivoire, Democratic Republic of the Congo, Guinea, Guinea-Bissau, Kenya, Mozambique, Nigeria, São Tomé and Príncipe, Senegal, Sierra Leone, Swaziland, Tanzania, Uganda, Zambia, and Zimbabwe.

**Box 2 (concluded)**

management failures in the banking sector. While a given crisis may contain elements of all three, emerging markets tend to be more prone to the first type of crisis while LICs (including SSA countries) are more prone to the second or third. One factor underlying the relatively quick recovery of financial depth after a crisis caused by macroeconomic factors is the rapid return of deposits to banking systems once an inflationary surge is gotten under control. Since fewer crises in SSA were purely macroeconomic in nature, this may explain why private sector lending increases

rapidly post-crisis in non-SSA crisis countries, but remains stagnant in SSA crisis countries (see the figure). Note in particular that as a group, SSA crisis countries have not returned to pre-crisis levels of private credit reached in the mid-1980s.

Experience therefore shows that financial sector development must be consistent with preserving the soundness of the banking system. Innovative approaches to expand financial services and increase financial intermediation must be market-driven and maintain prudent banking operations.

African countries are putting in place better financial sector infrastructure, including, for example, wholesale and retail payments systems, or book entry and electronic trading systems for securities. On payments systems, WAEMU and CEMAC both have recently implemented state-of-the-art real-time gross settlement (RTGS) and retail payments systems.<sup>10</sup> Most SSA countries that have either treasury or central bank bills have moved or are moving from paper-based securities to book-entry systems. Although there have been some technical problems with such systems—not least related to power supply and back-up—the inability of these systems to thrive seems to reflect underlying problems of financial market depth rather than narrow technical obstacles.

## Operating Environment

*Banks suffer from weak legal systems and unclear property rights. They face a regulatory framework that is largely consistent with international norms, but implementation of supervision is hampered by chronic forbearance. Most African countries have a range of monetary policy instruments, but in the presence of high and persistent excess liquidity they have not been efficient.*

## Legal Environment and Business Practices

Legal and institutional frameworks are generally poor in SSA, and progress has lagged behind recent

improvements in other LICs. The World Bank's *Doing Business* indicators show a legal framework index for SSA that is slightly lower than in comparator countries (see Appendix 5, Table A8). A credit information index, which measures the ability of financial institutions to obtain information on client creditworthiness, is also lower in SSA.<sup>11</sup> There is a strong correlation between private loans as a share of GDP and the indices for the extent of credit information and the legal rights of creditors (Appendix 5, Table A9).

Weak property rights and poor enforceability of contracts also constrain financial market activity. Surveys indicate that financial institutions in SSA are reluctant to lend because of difficulties in securing collateral and seizing assets in the case of loan defaults. *Doing Business* ranks SSA countries as the lowest in the world on the indicators necessary for efficient financial system operation: registering property, getting credit, protecting investors, and enforcing contracts (Appendix 5, Figure A4). Enforcing a commercial contract through the courts is more difficult in SSA than anywhere else: on average, creditors must go through 35 steps, wait 15 months, and pay 43 percent of country per capita income before receiving payment (World Bank and IMF, 2005).<sup>12</sup> This partly accounts for bank concerns about credit guarantees.

<sup>10</sup>Other countries also are considering regional solutions—given economies of scale and cost sharing—but regulatory and supervisory problems outside of monetary unions are more difficult to resolve.

<sup>11</sup>Public credit registries and private credit bureaus have low coverage across all groups, though coverage seems to be rising more rapidly for the non-SSA low-middle-income group (the low-middle-income countries comparator group includes low- and lower-middle-income countries). The World Bank country income categories based on gross national income (GNI) per capita in 2004 classify low-income countries as those having GNI of \$825 or less, and lower-middle-income countries as those having GNI of \$3,255 or less.

<sup>12</sup>World Bank and IMF (2005) provides other examples using data from the *Doing Business* survey. For example, Nigeria has the

## Regulation and Supervision

Many regulatory and supervisory requirements in SSA are largely in line with international norms, but implementation of supervision is often constrained (Appendix 4, Table A7).<sup>13</sup> For example, supervisors tend to be less independent. As a result, they have less power to demand “prompt corrective actions,” and there is generally greater forbearance. However, forbearance itself reflects underlying pressures such as the inability of banks to meet prudential requirements given countries’ economic structures or the possible costs of bank restructuring. As a result of forbearance, weak banks often remain in the system for too long. As long as banks have no effective ways to monitor the financial soundness of other banks, forbearance contributes to minimal interbank relations. Other impediments to effective supervision include serious resource constraints in supervisory agencies, and the generally weak accounting and auditing systems in place.

## Implementation of Monetary Policy

Most SSA countries outside the CFA zone and the rand Common Monetary Area (CMA) have moved from an exchange rate to a monetary anchor. In 1985, 21 countries outside the CFA and CMA zones maintained an exchange rate anchor; by 2004 only 6 small countries did (Appendix 5, Table A10). South Africa is the only country in the region that has an inflation-targeting regime. Successful inflation stabilization outside the CFA zone—marked by adoption of a monetary aggregate as the inflation anchor—has, since the mid-1990s, considerably narrowed an earlier large difference in inflation between CFA and other SSA countries. With limited capital mobility and incomplete regional financial integration, the central banks in the CFA franc zone have been able to pursue monetary targets along with the exchange rate anchor (Box 3).

most cumbersome regulations in the world for registering property (21 procedures, 27 percent of the property value in fees, and a registration period of 274 days). Such processes, similar to those in other SSA countries, help explain why adequate collateral is often a problem for borrowers.

<sup>13</sup>While to date less than half of SSA countries have participated in the IMF’s FSAP, for those that were assessed, compliance with some Basel Core Principles has been largely in line with results in other countries. However, compliance with the principle of independence of supervisors, and several principles related to prudential regulations, is relatively low, according to IMF staff calculations based on Financial System Stability Assessments.

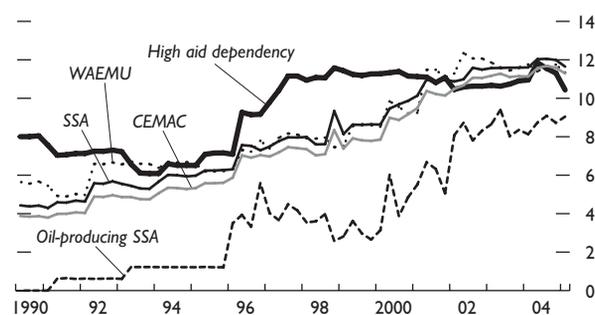
Effective reserve ratios in SSA are relatively high, and have been increasing since the mid-1990s (Figure 5).<sup>14</sup> In 2004, the average reserve ratio was 11.3 percent, with substantial variation (from a low of zero in the Central African Republic to around 50 percent in Zimbabwe). In many SSA countries, cash reserve requirements are supplemented by a liquid asset requirement (LAR) that is both a monetary tool and prudential device, though it is often also motivated by the desire to lower the costs of deficit financing.<sup>15</sup> Reserve requirements tend to be higher than in the United States and the euro area. Increases in required reserves reflect the heightened focus in the region on stabilizing inflation and on financial system stability. They are, however, also a response to increasing liquidity from, for example, aid and oil revenue inflows. With many countries only partially remunerating required reserves, if they do so at all, the use of this instrument is a heavy tax on banks.

Market-based monetary instruments include sales of foreign exchange and primary auctions of treasury bills. Several central banks hold weekly auctions of treasury bills. The absence of large institutional investors means that the auctions are often undersubscribed, and central banks sterilize excess liquidity by taking up the unsold bills. Sterilization occurs only if

<sup>14</sup>The effective reserve ratio is calculated as the ratio of statutorily required reserves to the sum of demand and time savings and foreign currency deposits.

<sup>15</sup>Studies generally find them both ineffective and distortionary as a monetary policy tool (Gulde, 1995) and a hindrance to secondary market development.

FIGURE 5  
Sub-Saharan Africa: Average Effective Reserve Requirement (Percent)



Source: IMF staff calculations.

### Box 3. Financial Integration in the CFA Franc Zone

The West African Economic and Monetary Union (WAEMU) and the Central African Economic and Monetary Community (CEMAC), the two monetary unions constituting the CFA franc zone, strive toward the creation of integrated regional financial markets. Key goals are (1) achieving larger market size, with more opportunities for risk sharing and diversification; (2) fostering a better allocation of capital among investment opportunities; and (3) potential for higher growth. Financial integration in the context of regional integration can be helped by formal efforts to integrate markets (see IDB, 2002). However, true financial integration occurs only where there is significant interaction among financial markets and prices for financial services converge.

Rules-based financial market integration in the WAEMU and CEMAC zones is advanced:

- There is a common currency, and a shared central bank in each subregion, and financial institutions face similar rules thanks to common institutions, including a regional supervisor. However, some key differences—for example, in the licensing of banks, which involves national ministries of finance—persist.
- In addition, there are no capital controls within each union and no cross-border restrictions on bank lending. Finally, similar accounting and legal frameworks have been adopted.

Market-based integration in both WAEMU and CEMAC has been slow to emerge:

- Interest rate spreads in WAEMU are not converging, and similar data for CEMAC are incon-

clusive. There is little progress toward the “law of one price” with respect to lending rates in WAEMU and/or CEMAC.

- In all CFA countries cross-border and interbank transactions appear to be limited. The only active market emerged recently in WAEMU, where there is evidence of cross-border transactions in the emerging treasury bill market.<sup>1</sup>
- Foreign ownership in the banking sector is high. Yet in most cases, the banks tend to be from France, indicating integration with Europe rather than with other African members of the zone. However, there is now some emerging cross-ownership of banks headquartered in the region.<sup>2</sup>

With a harmonized framework in place and early signs of regional activity, prospects for further financial integration among WAEMU and CEMAC are positive. Based on identified constraints, progress will, however, depend on economic development in the region more generally, a strengthening of the regional banking system, and the abolition of remaining formal and informal impediments, including differences in taxation, and the evenhanded application of the common regulatory framework.

<sup>1</sup>Based on available data, nonresident banks’ purchases of treasury bills ranged from 11 percent (Côte d’Ivoire) to 76 percent (Mali) of total issuance in 2004–05.

<sup>2</sup>For example, Gabonese banks own subsidiaries in Equatorial Guinea.

governments do not use the receipts of the treasury bill sales. Increasing government financing needs in some countries have limited the ability of open market operations to mop up liquidity. In certain cases, treasury bill rates are not fully market determined because the central banks have clear cut-off rates in mind and are willing to intervene if necessary. Central bank bill sales are often limited because of concerns about central bank profits. Secondary markets for securities largely do not exist except in South Africa and Mauritius.<sup>16</sup>

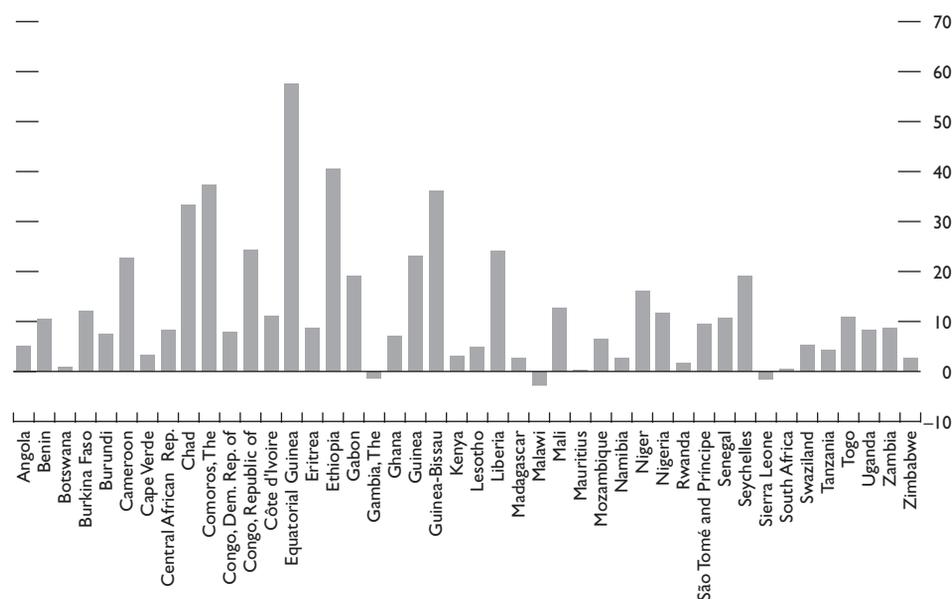
<sup>16</sup>Transitioning to greater use of market-based instruments is constrained by the limited interbank market and weaknesses in central bank liquidity forecasting. Country studies conducted in

### Market Liquidity

Despite increases in required reserves, most SSA banking systems hold significant unremunerated excess liquidity. On average, excess reserves were more than 13 percent of total deposits, though they exceeded 30 percent in Equatorial Guinea, Ethiopia, Guinea-Bissau, the Comoros, and Chad (Figure 6). While oil and aid flows are linked to persistent excess liquidity in some countries, fuller explanations relate to capital controls; structural

the IMF’s African Department on these and related monetary policy issues include Angola (Alvesson and Torrez, 2003); The Gambia (Harjes, 2004); Nigeria (Gobat, 2003); and Tanzania (Nassar, 2003).

**FIGURE 6**  
**Sub-Saharan Africa: Ratio of Excess Reserves to Total Deposits<sup>1</sup>**  
 (Percent, end-2004)



Source: IMF staff calculations.

<sup>1</sup>Where 2004 year-end data are not available, the most recent data point is used.

problems in financial systems (such as interest rate restrictions, perceived limited and risky lending opportunities, and asymmetric information); and underdeveloped government securities and inter-

bank markets. Excess liquidity is not only higher but also more volatile in oil-producing countries. It is also higher than the SSA average in both the CEMAC and the WAEMU zones.



## Economic Challenges

### Limited Access to Financial Services

*Access to financial services—savings and loans—is lower in Africa than in other LICs. Constrained by limited physical access to bank branches, high bank charges and/or administered interest rates, most households cannot afford to accumulate savings in a formal institution. Given lack of collateral, access to loans is even more constrained.*

#### Theory

Access to financial services for households is increasingly recognized as linked to growth and poverty reduction. Theory suggests that financial market imperfections may be particularly harmful for poor entrepreneurs without collateral, credit histories, or connections (Galor and Zeira, 1993). Credit constraints that limit poor households' ability to finance high-return projects can reduce the efficiency of resource allocation, lowering growth and poverty reduction. Evidence indicates that finance is a binding constraint to firm growth, particularly for small firms that tend to be drawn from and serve poorer populations (Beck, Demirguc-Kunt, and Maksimovic, 2005). Also, the entry of new firms—which rely partly on external finance—is an important channel through which finance contributes to growth.

#### Measuring Access

Data on access are scarce, given the weak statistical capacity in many LICs. Access can be defined as

the ability of individuals to get financial services that are affordable, usable, and responsive to their financial needs (DFID, 2005). Efforts by the World Bank and other development agencies to compile data recognize that access to and use of financial services can take many forms. (See World Bank, 2006, for a comprehensive review and agenda for improving financial access in SSA.) Ideally, measures should take account of the informal as well as the formal financial sector and distinguish by geographical area and type of financial instruments. Measuring access is complex; it may be necessary to rely on household surveys (see Box 4).

Given that branch networks are generally small and concentrated, physical access to financial services is difficult. There are about 15 branches for every 100,000 persons in 48 non-SSA low-, middle-, and high-income countries, yet the average is only 2.5 branches per 100,000 in the 35 SSA countries for which data are available (Beck, Demirguc-Kunt, and Peria, 2005; and IMF African Department Financial Sector Profiles, 2005). Average branch network density in SSA is similarly limited, with only 6 branches per 1,000 square kilometers compared with 34 for non-SSA countries in the sample.<sup>17, 18</sup>

<sup>17</sup>The size of a branch network may not accurately depict physical access to bank branches because banks in many countries concentrate their branches in urban areas. Data on the rural-urban distribution of bank branches are not available.

<sup>18</sup>The limited geographical coverage in Africa could be a result of low population density, constraining bank incentives to serve sparsely populated areas. However, average population density is at par with the world average.

#### Box 4. Expanding Financial Services in Africa: The Example of the FinMark Trust

Both countries and aid agencies are increasingly concerned with improving access to financial services for the poor. In March 2002, the United Kingdom's Department for International Development funded the FinMark Trust with the mission of "making financial markets work for the poor." Unlike earlier approaches, FinMark's work is explicitly based on micro foundations; it is benchmarking access and defining at the household level areas of unmet demand. FinMark activities are currently concentrated in South Africa, Botswana, Namibia, Lesotho, and Swaziland.

Initial surveys show important country-specific differences in access, the role of the informal sector, and, for those with access, preferences for financial services (see the table). From a third to half of the population

in the southern Africa region have no access to financial services; access is highest in South Africa. The typical financially excluded individual is poor, female, rural, and unemployed. The informal market is more prominent in Botswana and South Africa than in Namibia: in Botswana, 27 percent of respondents used both formal and informal markets, indicating complementarities between the two types. Among the financially included, savings and transaction products were more popular than insurance or credit products.

Information gathered from FinScope Surveys is crucial to formulation of policies to enhance access; follow-up surveys can help in assessing policy effectiveness. For example, FinScope contributed to the efforts of the South African government, industry, financial institutions, and labor and civil society institutions to promote formal adoption of a Financial Access Charter in October 2003. Under the charter banks and insurers are committed to provide certain products and services to low-income earners. New targeted instruments—such as Mzansi accounts<sup>1</sup>—have been created. FinScope in 2005 found that publicity has yet to reach all eligible households, but among those using the new instruments there was a significant group of "newly banked."

Data collection is being extended to Kenya, Nigeria, Tanzania, Uganda, and Zambia. The World Bank and FinMark are engaged in a conceptual collaboration on more standardized indicators of financial access in Africa, drawing also on the Bank's experience with surveys in Latin America and India. With more countries covered, it should be possible to extract best-practice experience.

#### Selected Findings from FinScope Surveys (Percent of respondents)

	Botswana	Namibia	South Africa
<b>General characteristics</b>			
Financially included	54	55	63
Served by banks	43	51	47
Served by other			
formal institutions	6	3	8
Served exclusively			
by informal market	5	1	8
<b>Product usage</b>			
Savings	51	50	...
Transactions	43	41	...
Insurance	33	25	...
Credit	21	22	...

Source: FinScope (2003).

Note: FinScope defines financially included individuals as those who use formal, informal, or interpersonal financial products (excluding transfers). Among this group, the "banked" refer to those who use at least one or more bank products. Formal providers include registered microlenders.

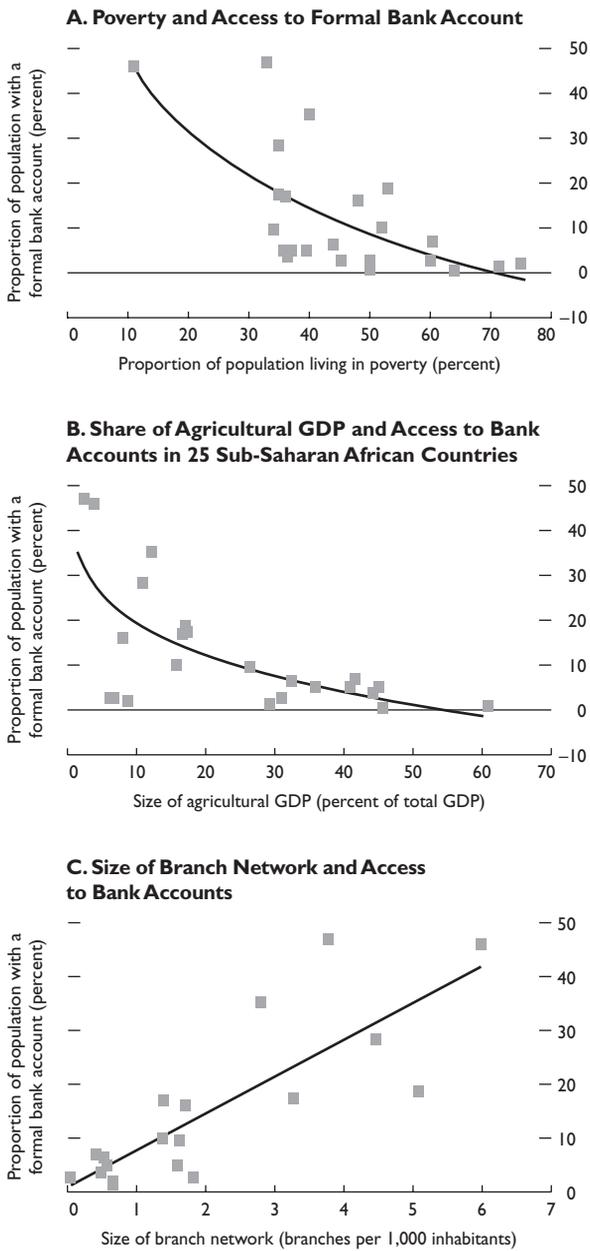
Few households have a formal relation to a financial institution. Household surveys show that, on average, in the 29 SSA countries for which data are available, only 11 percent of households had access to savings accounts, compared with 25 percent in other low- and middle-income countries and 90 percent in industrial countries (Claessens, 2005; and IMF African Department Financial Profiles, 2005). Chad and Central African Republic have the lowest access levels, with savings accounts held

by less than 1 percent of the population; by contrast, the figure is close to half the population in Botswana and South Africa.

#### Factors Constraining Access

Access to financial services in SSA is undermined by widespread poverty and a large agricultural base (Figure 7). Poverty limits the demand for savings facilities; the negligible amount of savings in turn

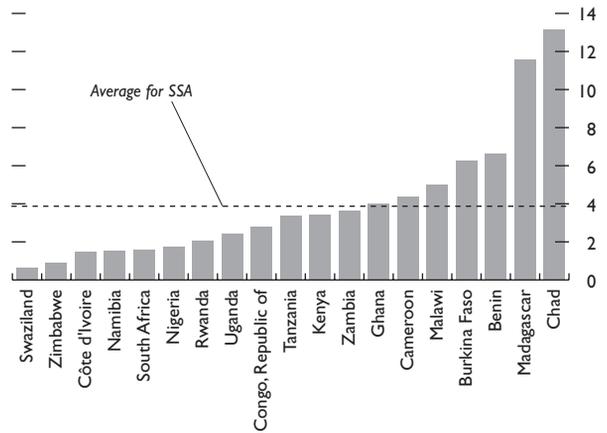
FIGURE 7  
**Sub-Saharan Africa: Access to the Banking Sector**



Sources: World Bank, *World Development Indicators*; Beck, Demirguc-Kunt, and Peria (2005); and IMF staff calculations.

raises the cost of supplying financial services. There is a strong correlation between access (share of the population having a formal savings account) and the per capita income and poverty levels of African

FIGURE 8  
**Sub-Saharan Africa: Average Savings in Commercial Banks**  
*(Relative to per capita income)*



Source: IMF staff calculations.

countries.<sup>19</sup> Access to savings accounts is lower in countries with a large agricultural base. Thin branch networks are also linked to low access. Lack of roads in turn seems to be a major impediment to broader branch networks and is also directly associated with minimal lending to the agricultural sector.

High banking charges for opening and maintaining a deposit account make access to bank services more difficult for small-scale savers. In some southern African countries high minimum balances and fees are the most common reason households cite for not having a bank account (FinScope, 2003). Very high opening minimum balances (in The Gambia, for example, the amount is equivalent to the country's per capita annual income) also restrict access. The tendency of commercial banks to serve larger and richer customers is evident from the high average savings per account in commercial banks, equivalent to four times the average annual income in a sample of 20 SSA countries (Figure 8). The size of the average savings account relative to per capita income is particularly large in lower-income countries (in Madagascar and Chad, for example, multiples are around 12 times per capita income).

<sup>19</sup>Non-oil per capita income was used in the case of oil-producing countries, given that a large proportion of the population does not benefit from oil revenues. Beck, Demirguc-Kunt, and Peria (2005) find similar evidence for African and non-African countries in a sample of 91 countries. Illiteracy levels, which are closely related to per capita income, are also correlated with access in SSA.

Remaining interest rate controls in some countries adversely affect commercial bank deposit taking and lending. Despite widespread liberalization beginning in the 1990s, interest rate controls remain in effect in many African countries. Among them are administratively set minimum deposit and maximum lending rates, often aimed at ensuring affordable loans and a significant return on deposits, particularly for customers of small-scale banks. Interest rate floors, however, make banks reluctant to accept further deposits, particularly where there is high bank liquidity and nonremunerated required reserves. Hence, the high real minimum deposit rates mainly benefit insiders who already have accounts (for the CEMAC countries, see IMF, 2005b). Maximum lending rates prevent banks from adequately pricing lending risk, especially in weak legal environments, which further constrains credit.

### Insufficient Financing of the Economy

Most sectors suffer from financing constraints, but agriculture faces the greatest challenges in accessing formal finance. Reasons for low levels of lending include high costs of financing, weak legal and institutional environments, and the relative attractiveness to banks of providing funds to the government.

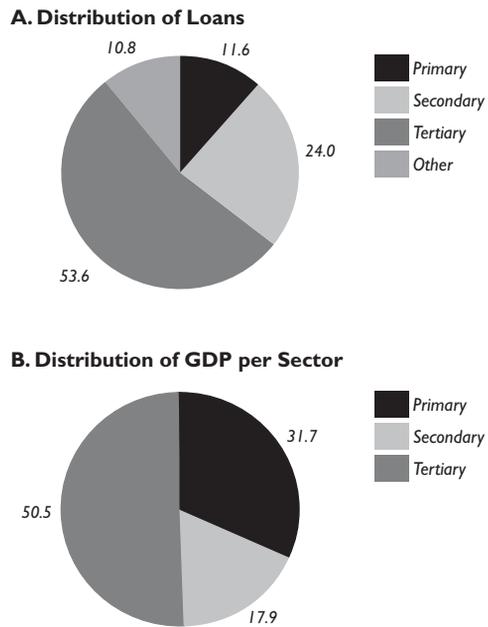
#### Empirical Findings

Access to credit and the cost of financing have been identified as key obstacles facing enterprises in Africa. Over half the companies included in a World Bank survey report that access to financing and its cost are severe constraints to company growth (Appendix 5, Figure A5).<sup>20</sup> A World Business Environment Survey identified high interest rates, bank collateral requirements, and inadequate credit information on customers as important obstacles (International Finance Corporation, 2000). As a result, banks in SSA provide only one-sixth of the working capital and investment funds of companies. Bank financing of small firms is even lower.<sup>21</sup>

<sup>20</sup>Based on World Bank Investment Climate Surveys in seven SSA countries: Eritrea, Ethiopia, Kenya, Senegal, Tanzania, Uganda, and Zambia.

<sup>21</sup>The World Bank Investment Climate Surveys also found that banks require high collateral—on average more than 170 percent of loan value.

FIGURE 9  
Sub-Saharan Africa: Distribution of Loans and GDP by Sector (Percent)



Source: IMF staff calculations.

#### Sectoral Distribution of Current Lending

The sectoral distribution of bank lending relative to the sectoral distribution of economic activity reflects differences in access to financial services. While sectors other than the primary account for two-thirds of economic activity in SSA, they receive almost 90 percent of all commercial bank loans (Figure 9). Moreover, in the majority of countries—essentially the poorest, predominantly agriculture-based, economies—banks lend mainly to the domestic and external trade sectors. In a few less poor countries that have a relatively large commercial manufacturing base, such as Kenya, Lesotho, Uganda, and Senegal, manufacturing is the main recipient of bank credit. In middle-income countries (Botswana, Gabon, Mauritius, Namibia, and South Africa), household consumer credits appear dominant, accounting for an average of 33 percent of total private sector loans.

Agriculture accounts for a significant part of economic activity and employment, but it receives a small and declining share of commercial bank credit

(6 percent in 2002). Over the past decade, in two-thirds of 31 countries for which data are available, the share of loans to agriculture has shrunk. That share fell while the sector was growing in nine countries and in seven more it declined by more than the decrease in the sector's share in GDP. The low share of agricultural loans seems to be strongly linked to the limited size of bank branch networks, which makes it difficult for banks to service rural clients.

### Main Impediments to Increased Lending

Real lending interest rates in SSA are among the highest in the world. In 2004, the average real lending rate in SSA was 13 percent, compared with an average of 8 percent in other low- and middle-income countries and 3.5 percent in OECD countries (Appendix 3, Figure A2).<sup>22</sup> Given shallow financial systems, very limited equity and bond markets, and little or no foreign financing, firms in most SSA countries depend on bank financing, which makes them more vulnerable to high interest rates than firms in other developing regions. Given the excess liquidity, persistent high real interest rates reflect interest rate restrictions, collusive market behavior, and high lending risk.

Deficiencies in property rights systems for both movable property and land have impeded financial intermediation in SSA. Land titles in SSA are subject to considerable uncertainty due to lack of documentation, overlapping systems of rights and ownership, and overstretched legal systems. In some countries (Ghana and Tanzania, for example), the problem is compounded by adaptations of "crown title," in which all land is deemed to be owned by the government (Tanzania is now working toward developing individual land titles). In addition, in many countries, large amounts of land are held by the community, presenting even more of a problem for land titles than government land did. When a title does exist, stamp duties and legal fees impose high transaction costs on its use as collateral. Financial sector assessments in the region have consistently found that mortgage finance is underdeveloped in part because of these constraints. There are also substantial problems with registering title

<sup>22</sup>Real lending rates are highest in the WAEMU and CEMAC countries (based on maximum lending rates), averaging 17.5 and 15.5 percent, compared with 11 percent and 9 percent in low-income and middle-income non-CFA countries, respectively.

in movable property, such as cars. For example, when movable property is used as collateral in Rwanda and Senegal, it often must be physically surrendered for the duration of the loan, which negates the advantages that securitized loans would otherwise offer.

### Government Borrowing as an Impediment

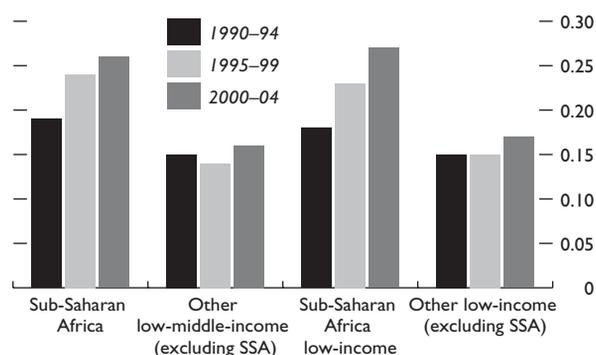
Rather than lending to the private sector, SSA banks increasingly lend to the government or buy government debt instruments. Balance sheets of commercial banks show a sharply rising weight of claims on the government compared with claims on the private sector. The ratio of claims on the central government to total domestic claims increased to over 25 percent in 2000–04: 8 percentage points above the figure for other low- and middle-income countries (Figure 10).<sup>23</sup> From 1995 to 2004, while claims on the government grew faster than claims on the private sector in SSA, the pattern was strongly reversed in other LICs (Appendix 5, Figure A6).<sup>24</sup> Within SSA, CFA countries have lower government claim ratios, reflecting more recent introduction of government debt markets (in the WAEMU) and higher government deposit shares (partly due to the presence of oil exporters in the CEMAC).

Government domestic debt can help bank lending to the private sector but most of the benefits must be weighed against concerns about public debt. Modest domestic debt can support financial intermediation in three ways: (1) low-risk government debt can help compensate for the high risks of private sector lending, allowing it to increase within prudential limits on risk-weighted capital asset ratios (Kumhof and Tanner, 2005); (2) the yield curve on domestic debt instruments provides a benchmark for private sector debt markets, including bank lending; and (3) greater reliance on domestic debt instruments rather than money financing (for a given level of domestic financing) contributes to macroeconomic stability. Some SSA countries do not yet issue treasury bills,

<sup>23</sup>An increasing share of government claims in total claims can be consistent with the trend toward fiscal deficit reduction in SSA, to the extent that higher bank financing compensated for financing through arrears and the central bank, which has been declining in SSA.

<sup>24</sup>Reserves and foreign assets also account for more asset growth in low-income SSA countries than claims on the private sector.

**FIGURE 10**  
**Sub-Saharan Africa and Comparator Groups:**  
**Banking Sector Claims on Government**  
*(Ratio to total claims)*



Source: IMF, *International Financial Statistics*.

which limits the financial sector development benefits from government debt. Domestic debt issuance, however, also absorbs domestic savings, increases interest rates, and crowds out lending to the private sector. The empirical evidence on the impact of domestic debt on private sector credit is mixed.<sup>25</sup>

## Implementation of Monetary Policy

*The effectiveness of monetary policy implementation in SSA is constrained by inefficient and shallow financial markets. Structural excess liquidity in the banking system, shallow interbank markets, underdeveloped thin government securities markets, and insufficiently deep and liquid foreign exchange markets all hinder monetary policy implementation. At the same time, the use of “rules-based” monetary instruments can impose significant costs on banks.*

### Excess Liquidity

Excess liquidity in the banking system limits the effectiveness of monetary policy. Where excess liquidity is high, changes in the required reserve ratio will not lead to an adjustment in liquidity in the

<sup>25</sup>Christensen (2004) and Adam and Bevan (2004) find some evidence of crowding out in African countries; IMF (2005c) finds a mixed impact in a broader sample of LICs; and Detragiache, Gupta, and Tressel (2005) find the effects insignificant.

economy. Monetary policy is likely to be particularly ineffective in banking systems where excess liquidity is involuntary, because banks have no alternative investments. Under these circumstances, excess reserves reflect a very low marginal return to lending net of intermediation costs.<sup>26</sup> Policy instruments that alter the monetary base may have little or no effect on lending conditions and broader monetary aggregates—and therefore little effect on economic activity. If the liquidity is held for precautionary reasons, a change in required reserves may still be partly effective.<sup>27</sup> Recent empirical studies support this hypothesis: in Nigeria and Uganda, money supply innovations were found to have a larger effect on inflation when involuntary excess reserves were low than when they were high (Saxegaard, 2006).<sup>28</sup>

### Shallow Interbank Markets

Shallow interbank markets interfere with the interest rate transmission mechanism. Money market operations are most effective when the liquidity operations of the central bank, which may be dealing with only a few banks, are disseminated through interbank activities to all banks. In shallow interbank markets, the central bank’s liquidity impulses are not effectively transmitted: weak banks cut-off from the interbank market turn directly to the central bank to meet liquidity shortfalls (IMF, 2004). In many cases, therefore, central banks withdraw and inject liquidity at the same time.

### Small or Nonexistent Markets for Government Securities

Direct financial links between the central bank and the government complicate monetary management. Where treasury bills do not exist, governments often have direct access to central bank

<sup>26</sup>Banks may be unable to lend if regulation creates an artificial floor on deposit rates and ceiling on lending rates, and limits the ability of commercial banks to reduce deposits or expand lending. Banks—particularly those with monopoly power in the loan market—may also be unwilling to lend when transaction costs are high and risk-adjusted returns low.

<sup>27</sup>Precautionary reasons for liquidity might include volatility in the deposit base, unavoidably high lending risks, or poorly developed interbank markets and similar structural factors.

<sup>28</sup>In the CEMAC region, the transmission mechanism was weak in both high and low (involuntary excess reserves) regimes, which was explained by the fact that involuntary excess liquidity (involuntary excess reserves) was relatively high across the whole sample period.

credit to finance budget deficits. Under these circumstances, it is difficult for the central bank to control the size and composition of its balance sheet. This limits its ability to effectively influence overall liquidity (IMF, 2004).

Thin government securities markets can contribute to interest rate and inflation problems, via the fiscal channel. Because domestic debt markets in SSA are typically not closely integrated with global capital markets, domestic interest rates can deviate substantially from uncovered interest parity rates. When bond financing is used but bond markets are thin and underdeveloped and bonds have short maturities, interest rates may rise sharply, destabilizing the budget and, through higher seigniorage requirements, aggravating inflation.<sup>29</sup> Use of government or central bank securities for monetary control is complicated by strong links to interest rate and inflation volatility (Adam and O'Connell, 2006).

### Shallow or Nonexistent Foreign Exchange Markets

In SSA, as in some other developing regions, there are structural impediments to deepening interbank foreign exchange markets. Market concentration—only a few financial institutions controlling the bulk of transactions—and foreign exchange regulations limit depth and efficiency (Canales-Kriljenko, 2003). Other restrictions are foreign exchange surrender requirements (still in place, although declining); interbank requirements that dealers trade only with customers, not among themselves; and tight prudential limits on net open foreign exchange positions.<sup>30</sup> Additional constraints in SSA are foreign exchange auctions that often lack transparency and are too infrequent; high red-tape

<sup>29</sup>Interest rate liberalization was associated with sharp increases in real interest rates in many countries. For the 15 countries with outstanding debt in both periods, the median ex post real interest rate rose nearly 10 percentage points between 1985–89 and 1995–2000; in the full non-CFA sample, median interest payments on domestic debt amounted to 15 percent of fiscal revenues in 1995–2000 (see Christensen, 2004). In addition, in the late 1990s, high real interest rates and rapidly mounting interest burdens discouraged the use of bond sales for monetary control in Uganda and Tanzania (Buffie and others, 2004).

<sup>30</sup>While these restrictions contain risks and prevent speculative activity, they should be balanced against the need for dealers to take open positions to provide liquidity to the market (Canales-Kriljenko, 2003).

and processing costs in formal markets (contributing to the remaining parallel markets in a few countries); and lack of clarity on the objectives of central bank foreign exchange intervention (such as liquidity management, smoothing short-run excess volatility, or exchange rate targeting).

Without deep and efficient foreign exchange markets in SSA, central banks face problems with foreign exchange intervention policies. While many SSA countries have moved to more flexible exchange rate regimes, most de facto outcomes—observed patterns of intervention and short-run nominal exchange rate volatility—show less flexibility.<sup>31</sup> Substantial central bank intervention in the market is the norm in many countries. These interventions prevent the transmission of market signals to official rates, often bringing de jure flexible exchange rate systems into close proximity to fixed-rate regimes. It has been argued that the most important constraint to free-floating exchange rate regimes for low-income countries may be the absence of financial markets that would allow domestic firms to hedge the risks associated with temporary exchange rate movements (Montiel, 2003).

### Rules-Based Monetary Instruments

Central bank reliance on rules-based, quasi-direct monetary policy instruments imposes costs on financial institutions. Unremunerated required reserves are an implicit tax on banks. High and rising reserve requirement ratios in many countries are steadily increasing the burden on banks. High reserve requirements can also contribute significantly to high interest rate spreads (for Malawi, see, for example, Mlachila and Chirwa, 2002). If reserves are remunerated only partially, or not at all, this creates an incentive for borrowers and depositors to bypass the depository system and for banks to create new products instead of reserveable liabilities (IMF, 1996, 2004).<sup>32</sup>

<sup>31</sup>For most SSA countries, calculations of the Reinhart and Rogoff (2005) measure of ex post exchange rate flexibility indicates substantial intervention even for countries notionally committed to a floating exchange rate (Masson and Pattillo, 2005).

<sup>32</sup>IMF (2004) also points out that, to encourage banks to trade with each other in the interbank market, remuneration rates on reserves deposited with the central bank should be lower than the cost of borrowing from the central bank at the discount window.



## Financial Sector Reforms

Many SSA countries have been taking measures to address some of the financial sector challenges, but problems remain. Reforms are often undertaken in response to surveys—at times in the context of a country’s participation in the Financial Sector Assessment Program—that have identified a wide range of obstacles. Financial sector reforms are also increasingly part of IMF-supported program conditionality.<sup>33</sup> These reforms follow up on an earlier generation of financial sector liberalization efforts where some progress was registered in a few countries (Box 5). But, overall, the effects of these reforms have remained limited largely due to incomplete coverage, inappropriate sequencing, and initiation in the context of macroeconomic instability (see Appendix 1).

<sup>33</sup>A recent study of IMF-supported programs for 83 countries measured financial sector conditionalities in three ways: intensity (number of financial sector conditions per program per year), hardness (share of prior actions and performance criteria in total program measures), and compliance (proportion of program measures implemented as scheduled) (Giustiniani and Kronenberg, 2005). Intensity has not risen as sharply in SSA as elsewhere in the world because there are no programs driven by financial crises. Nevertheless in the 27 SSA countries for which programs initiated in the early and mid-1990s could be compared to those in the late 1990s to 2001, financial sector conditionality increased by 60 percent. In SSA, “harder” types of banking sector conditionality have been increasing: this measure was higher than the global average in 2000–03. As in the rest of the world, compliance declined over 1995–2003, and was lower than in other areas of structural reform (Appendix 5, Figures A7, A8, and A9).

### Microfinance

*Governments and nongovernmental organizations (NGOs) are promoting microfinance as a vehicle to support access to financial services by the poor. The sector has been growing fast, and has been successful in creating instruments aimed at the poor. However, it remains much smaller than the banking sector and suffers from low profitability.*

Over the past few years, many SSA governments and NGOs have promoted microfinance institutions (MFIs) as a response to the limited access of households.<sup>34</sup> More than half of the MFIs in the Consultative Group to Assist the Poor (CGAP) database were created after 1998, and the number of members almost doubled from 2001 to 2003.<sup>35, 36</sup>

<sup>34</sup>The sector comprises NGOs, nonbank financial institutions, credit unions and cooperatives, rural banks, savings and postal financial institutions, and, in some cases, even commercial banks.

<sup>35</sup>This section is mainly based on a database of 167 MFIs in 37 SSA countries, which was created in 1998 by the CGAP for reporting MFIs in developing countries. While the database coverage is generally good, it is not exhaustive. In some cases it underestimates the true size of the MFI sector. The database distinguishes between three different types of MFIs: (1) regulated (banks, regulated NBFIs, regulated NGOs); (2) cooperative (financial cooperatives and credit unions); and (3) unregulated (other NGOs, NBFIs, MFI projects, and others). However, detailed soundness indicators for these institutions were available for only 27 SSA countries. We have supplemented the database information with credit union data for 15 SSA countries from the World Council of Credit Unions and postal savings banks data from the World Savings Banks Institute.

<sup>36</sup>For the 86 SSA MFIs that provided information continuously for 2001–03.

### Box 5. Financial Sector Reform in Uganda and Senegal

#### Uganda

By the late 1980s, Uganda's financial sector had become small and fragile. A combination of heavy-handed government intervention (interest rate controls, directed credit) and high inflation resulted in a severe case of financial disintermediation. Real interest rates were negative; the credit-to-GDP ratio, at just four percent, was less than one-fourth of its mid-1970s level; and the two dominant banks, which accounted for about two-thirds of the commercial banking system, were insolvent and required massive liquidity support from the Bank of Uganda (BOU, the central bank) to operate.

The reform of the financial sector began in earnest only after Uganda had achieved macroeconomic stability in the early 1990s.<sup>1</sup> The initial focus of the reform was liberalization. Interest rate controls were removed, barriers to the entry of new banks were reduced, and directed lending was restricted. As a result of these measures, and helped by single-digit inflation, nominal interest rates fell while real rates became positive and stabilized. Despite the encouraging signs, however, the financial system remained weak. More than half of all loans were nonperforming, intermediation margins remained high, and the country-side lacked basic financial services.

In order to address these weaknesses, the reform focus shifted to institution building in the mid-1990s. The legal and regulatory framework was upgraded to enhance market discipline and competition among the private sector banks and to allow the BOU to become an effective supervisor of the banking system. Furthermore, the government sold its ownership stake in the commercial banks and introduced a mechanism for resolution of bad debt.

In this context, privatization of the Uganda Commercial Bank (UCB)—Uganda's largest, accounting for a half of the banking business and more than 80 percent of the national branch network—was a milestone. Even though the first attempt to privatize the UCB, in the late 1990s, failed due to irregularities in the transaction, its subsequent acquisition by the South African bank Stanbic in 2002 has led to an improvement in service quality, outreach, and efficiency throughout the banking system. Banks have been diversifying their asset portfolios in favor of

loans to the private sector and away from government securities. The total number of accounts has grown, and it is estimated that every third household has a bank account, a good coverage by regional standards.

The reform was successful at turning around what had been an unviable financial sector and at improving intermediation (see the figure), yet further development will require addressing the economy-wide structural problems. Over the past 15 years, the M2-to-GDP ratio almost doubled, the fraction of nonperforming loans fell dramatically, and the financial sector became one of the most profitable and well-supervised in SSA. Nevertheless, both loans and deposits remain concentrated among a few large customers, reflecting both the structure of the economy and the size of the banking system. Intermediation remains low by regional standards, held back by structural impediments to lending, such as poorly defined and enforced property rights and outmoded insolvency laws. As those impediments are being removed, the financial sector is well-positioned to expand and to contribute to further development of Uganda's economy.<sup>2</sup>

To build on Uganda's past progress in order to promote a deeper and more efficient financial sector, a number of challenges remain. These include reducing the structural impediments to lending (e.g., contract enforcement problems, poor credit discipline and information sharing, and limited collateral), promoting competition, and minimizing distortions from subsidized lending while maintaining an effective supervisory regime. Diversification of the financial sector is important in the longer term: by restructuring the pension system, promoting long-term finance through nondistortionary challenges, and developing capital markets (Peiris, 2005).

#### Senegal

Senegal has recovered well from a severe banking crisis in the late 1980s and early 1990s. At the peak of the crisis, about half of all loans were nonperforming and one quarter of the banking system was facing insolvency. The government closed six commercial banks and one development bank, and the fiscal cost of the consolidation was nearly 20 percent of GDP. The major sources of vulnerability were supervisory failures, distortions

<sup>1</sup>The timeline and the elements of Uganda's financial sector reform are described in Aleem and Kasekende (2001).

<sup>2</sup>For an in-depth discussion see World Bank and IMF (2004), Hauner and Peiris (2005), and Peiris (2005).

tions arising from public ownership and interference, a narrow economic base, and the financial impact of the government's price setting policies in utilities and commodities. While the narrow economic base is a structural problem that is difficult to change in the short-term, the other vulnerabilities have been addressed to varying degrees by the Senegalese authorities, the BCEAO and the Regional Banking Commission created by WAEMU after the crisis.

Financial soundness indicators for Senegal are stronger than for WAEMU as a whole. NPLs in 2005 were about 13 percent, with at least 63 percent provisioning. Almost all financial institutions are now privately owned, and directed lending has been curtailed. Profitability in the banking sector recovered sharply from the crisis years, due to the consolidation, and the economic growth and return of deposits from abroad following the CFA devaluation in 1994. Even with extensive provisioning for bad loans, banks were able to strengthen their capital base; total bank capital nearly trebled from 1996 to 2001, and a high rate of compliance with capital adequacy requirements has continued to date. Nevertheless, risk concentration is still high, due to exposure to a few large parastatals.

More broadly, the willingness of banks to expand credit service provision beyond their traditional clients is reliant upon improved confidence in accounting systems and foreclosure procedures; both have significant weaknesses, which the government is now in the process of addressing.

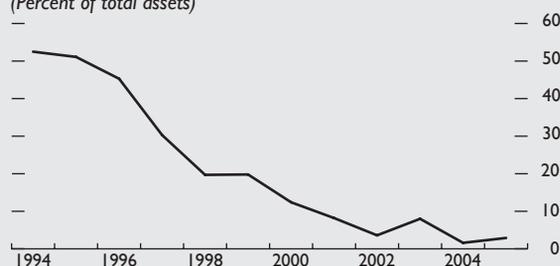
Senegal's dynamic microfinance sector is showing interest in meeting some needs of small and medium enterprise (SME) borrowers. The six largest microfinance networks (accounting for about 90 percent of deposits and clients) are financially strong and have the potential to engage in SME lending. SMEs have been underserved by Senegal's commercial banking sector, which has been reluctant to expand lending beyond large corporate clients.

Because MFIs specialize in alternative forms of collateral and information gathering, they have some scope to enter the SME market while complementary policy measures to address commercial bank lending constraints are also undertaken.<sup>3</sup> Two microfinance

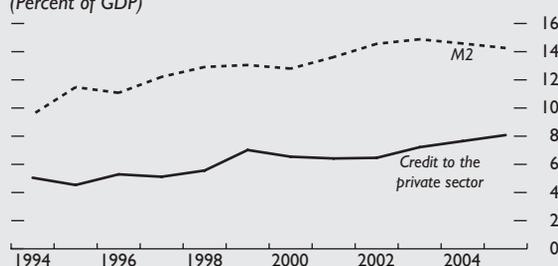
<sup>3</sup>To date, other measures to address SME lending constraints in Senegal have a poor track record, such as guarantee funds and interest subsidies.

### Uganda and Senegal: Financial Indicators

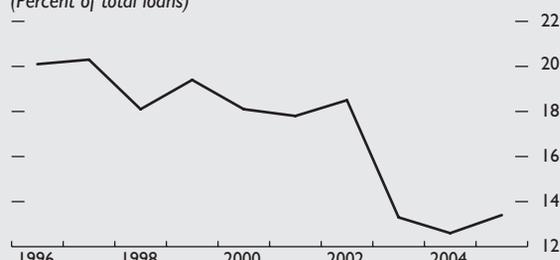
**Uganda: Nonperforming Loans**  
(Percent of total assets)



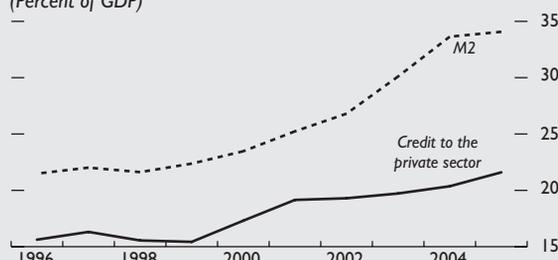
**Uganda: Credit to the Private Sector and M2**  
(Percent of GDP)



**Senegal: Nonperforming Loans**  
(Percent of total loans)



**Senegal: Credit to the Private Sector and M2**  
(Percent of GDP)



Sources: IMF, *International Financial Statistics* and *World Economic Outlook*.

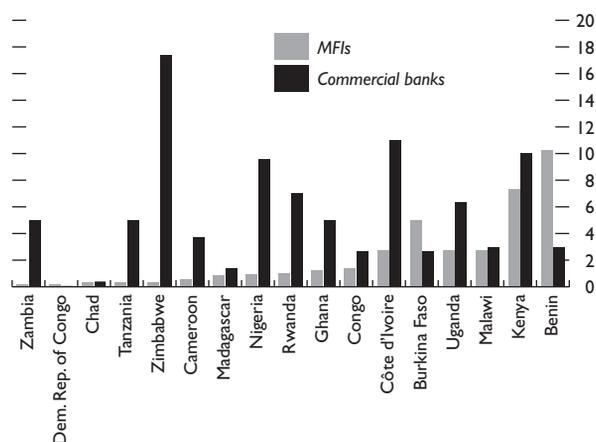
## Box 5 (concluded)

networks are planning to obtain commercial banking licenses and the Alliance de Credit et d'Épargne pour la Production (ACEP) network has been able to expand its services to firms through a line of credit from the International Finance Corporation. However, MFIs are unable to obtain lines of credit from large local banks, and interest rate ceilings can be more likely to bind for a MFI than a commercial bank, because of their high loan transaction costs.

Senegal faces important challenges in enhancing bank soundness and improving credit availability. The

government is in the process of addressing some of these weaknesses through a plan to improve the performance of the judiciary system on commercial and banking issues, particularly by simplifying procedures for loan and collateral recovery; strengthen accounting systems; and raise the capital adequacy ratio above 8 percent (this would require action at the WAEMU level) (IMF, 2006). More broadly, increased outreach of the financial system requires better integration of its components (regional capital market, banking sector, and MFIs).

FIGURE 11  
Sub-Saharan Africa: Access to Financial Services of Microfinance Institutions and Commercial Banks  
(Percent of total population)



Sources: Consultative Group to Assist the Poor (CGAP) database; Claessens (2005); and IMF staff calculations.

However, penetration of the sector is still modest. On average, only 2.5 percent of the population has an account with an MFI; in most countries, this is fewer than those reached by commercial banks (Figure 11 and Table 3). Microfinance sector assets account on average for 1.3 percent of GDP and 6 percent of commercial bank assets (Figure 12), though these shares are substantially larger in some countries (Box 6). On average, institutions in the WAEMU perform better and reach a larger share of the population. Outreach and the size of the sector are also greater in the East African Community countries (Kenya, Uganda, and Tanzania).

Microfinance institutions play a critical role in offering a range of financial services to the poor in SSA who traditionally lack access to finance. MFIs can also have multiple spin-off benefits, including being a part of effective poverty reduction strategies. African MFIs are diverse in terms of their membership, numbers, market niches, and operation. They range from traditional group-based activities and saving and credit cooperatives to specialized lending and project-related financing by NGOs and banks, as well as development projects with credit and grant components. African MFIs have played a more active role than MFIs in other regions in offering savings products. A CGAP survey of 163 MFIs found that in 2003 these institutions served almost 3 times as many savers as borrowers (Lafourcade and others, 2005).

Despite its small size, microfinance seems to be effective in targeting the poor. The microfinance system is significantly larger in poorer countries where the formal financial system is relatively small.<sup>37</sup> There is also a significant inverse relationship between the number of accounts in MFIs and the number in commercial banks, suggesting that microfinance, to some extent, compensates for the limited outreach of the formal financial system. The average outstanding MFI loan per borrower is \$307, equivalent to three-quarters of average per capita income, and the average savings balance is \$141, less than half of average per capita income.<sup>38</sup> In contrast, the

<sup>37</sup>This relationship only holds when credit unions are excluded from the sample, which is sensible; these institutions are often linked to larger enterprises.

<sup>38</sup>On average, these loans are somewhat bigger than in the Middle East and North Africa, East Asia, and South Asia, but

TABLE 3

**Sub-Saharan Africa: Microfinance Sector Indicators**

	People Served (percent of total population)	Size (Assets)		Return on Assets (weighted by assets)	Nonperforming Loans (percent of total loans, weighted by assets)	Operational Self-Sufficiency Index <sup>1</sup>
		Percent of commercial bank assets	Percent of GDP			
Sub-Saharan Africa	2.7	5.2	1.3	-5.7	10.2	108.4
WAEMU	5.1	6.1	1.4	-2.5	2.6	101.7
CEMAC	0.9	2.2	0.3	-1.4	9.9	104.9
East Africa Community	6.8	12.3	4.1	-0.5	14.2	115.4
SACU	1.1	5.6	1.3	-23.1	4.8	82.6
Non-CFA	2.3	5.4	1.4	-6.6	11.9	110.2

Source: IMF staff calculations, based on the Consultative Group to Assist the Poor (CGAP) database on reporting Microfinance Institutions (MFIs), which has information for 167 MFIs in 37 SSA countries. Database is supplemented with credit union data for 15 SSA countries from the World Council of Credit Unions.

<sup>1</sup>Operational self-sufficiency index measures the extent to which operating revenue covers operating costs.

average deposit in commercial banks is four times the average per capita income.

However, the costs of borrowing from MFIs are relatively high, partly reflecting their high operating costs. The average real lending rate for MFIs is 43 percent and the median is 29 percent, with a large variance across countries. These rates are generally higher than those of commercial banks (12 percent on average in 2003). The high borrowing costs are related to operating costs that are higher than those for MFIs in other regions, as well as to high fixed costs created by weak infrastructure, low rural population density, and high labor costs (Lafourcade and others, 2005). Given that MFIs mainly lend to small and medium-sized enterprise clients, the rates may also reflect a risk premium.

MFIs in SSA, on average, maintain a relatively high portfolio quality but most are not profitable. While there are wide differences between countries, overdue loans amounted on average to 7 percent of the total loan portfolio of MFIs at end-2003, only half the ratio for commercial banks.<sup>39</sup> Portfolio quality measures are also significantly better than those for MFIs in other developing regions. Internally generated revenues, on average, cover total operating costs (financing and operating costs and loan loss provisions), but profitability is low. However, given significant fixed costs, in

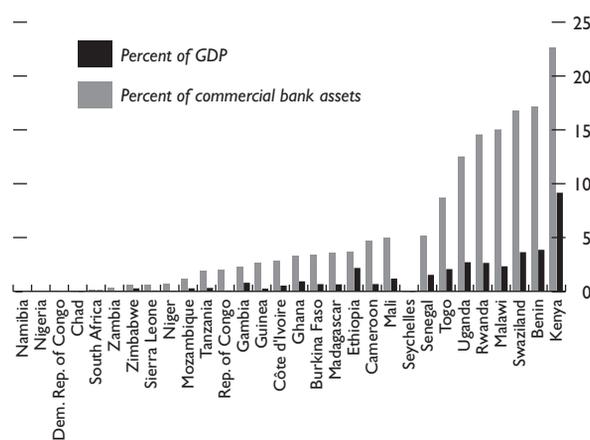
significantly smaller than those offered in Eastern Europe, Latin America, and the Caribbean (Lafourcade and others, 2005).

<sup>39</sup>This is explained in part by the fact that there are many new MFIs with recently extended loans. The share of NPLs tends to increase over the life of a loan.

two-thirds of the 37 surveyed countries, the return on assets (ROA) is on average negative. Operational self-sufficiency and profitability are lowest in NGO-driven MFIs and highest in credit unions and licensed MFIs. MFIs in SSA tend to be less profitable than those in other developing regions.

Evidence suggests that formal and informal financial institutions can complement each other. Though microfinance cannot achieve the scale of the formal financial sector, it is serving groups that the formal sector has difficulty in reaching (Honohan, 2004).

Figure 12  
**Sub-Saharan Africa: Size of the Informal Financial Sector**  
(Percent)



Sources: CGAP database; and IMF staff calculations.

**Box 6. Microfinance in Sub-Saharan African Countries**

To varying degrees, African microfinance institutions (MFIs) have been successful in mobilizing deposits and providing access to micro-credit:

Uganda's microfinance sector has thrived due to skilled human resources, entrepreneurial clients, and policymakers who have fostered an enabling environment. A liberalized interest rate structure has allowed MFIs to recover the high cost of providing microfinancial services and lowered dependence on donor funding. Uganda's "tiered approach" to regulation has facilitated greater product and service innovations by MFIs. MFIs are categorized in different tiers, depending on the type of deposit-taking activities and extent of capitalization and are subject to different levels of scrutiny. For example, credit-only MFIs and cooperatives are not regulated. In 2004, around 2 percent of the population were microfinance borrowers, and around 70 percent of these borrowers were women (Porteous, 2006). MFIs in Uganda are more profitable than the regional average. While MFIs offer a wider range of financial products, following recent competitive pressure from the entry of banks and consumer lenders, profitability is being squeezed.

Senegal's microfinance sector has grown at a robust rate since the early 1990s. From 1993 to 2003 the number of MFIs increased over 10 times, the number of service points increased three times, and the number of clients increased more than 33 times (3.5 percent of the population now has an MFI account). MFI clients are poorer, but slightly more educated than national averages, suggesting that there may be some barriers to access for households with limited human capital (BCEAO and CGAP, 2005). The rapid expansion of the sector has created many small and weak MFIs, straining supervisory capacity.

Cameroon's microfinance sector is extensive, but undergoing consolidation. There are more than 700 institutions, mostly savings and loan cooperatives, serving about 1.2 percent of the population. MFIs have built on the popularity of informal sector tontines (savings clubs) and some offer a special tontine instrument called "flash cash" which effectively serves as a money order. Many MFIs in Cameroon were launched through private initiative with little donor support. However, multiplication of unsound cooperatives has prompted the authorities to initiate a major cleanup of fraudulent MFIs and enforce a new regulatory framework.

MFIs are accorded a prominent role in Kenya's Economic Recovery Strategy launched in 2003. Kenya's microfinance sector is one of the largest and most mature in SSA: assets are close to a fourth of those in commercial banks and 9.2 percent of GDP, and the sector serves 14 percent of the population. Operations of banks and MFIs are increasingly overlapping. One of the most prominent MFIs has obtained a banking license, and in the other direction a large commercial bank is diversifying into the provision of credit to microenterprises. A confusing plethora of regulations apply to MFIs in Kenya while a comprehensive microfinance bill introduced in 2002 is still pending. Several fake MFIs have been perpetrating fraud on poor households in this weak regulatory environment.

Benin's microfinance sector suffered from deterioration of the main umbrella organization during 1998–2001, but has been rehabilitated. After the collapse of the banking system at the end of the 1980s and the liquidation of the agricultural bank, the rural credit network was organized under an umbrella organization, which remains the largest microfinance network in the country. Its financial situation deteriorated due to a worsening credit portfolio, but it has recovered since then. The sector has reached a significant size following steady growth in the last decade. Total deposits and credits of MFIs were about 9 percent of the deposits and 22 percent of credits of commercial banks. The sector serves close to 10 percent of the population, with substantial outreach to the poor. As in other countries in WAEMU, different types of institutions fall under different regulatory regimes, and there is a need to improve the regulatory structure.

The microfinance sector in Gabon remains underdeveloped and most existing institutions are financially vulnerable. Unlike most other countries in the region, Gabon does not have a strong tradition of informal rotating savings and credit associations and this lack of experience hampers MFI development. Limited profitable economic activities in rural areas, and low population density also constrain the sector. Loan repayment rates rarely exceed 50 percent and even the oldest MFIs are not operationally self-sufficient. There is, however, substantial unmet demand for micro savings products.

Commercial banks in many countries are increasingly entering microfinance markets (CGAP, 2004), and a few large MFIs are transitioning to become banks. The expansion of MFIs will depend on continued subsidization for some types of institutions and more market-oriented growth for others. Many donor-financed and NGO-based MFIs, which target the poorest, are not able to cover their costs and will continue to rely on subsidies. MFIs that are operationally self-sufficient, in contrast, can expand if they are prudent in their operations and diversify their portfolios.

### Key Forward-Looking Challenges for the Microfinance Sector

- **Adequate regulation:** Regulatory and supervisory frameworks for the microfinance sector must balance facilitating the long-term sustainability of MFIs and avoiding placing an undue burden on the regulatory body.
- **Maintaining soundness:** Rapid growth of the microfinance sector in some countries has led to soundness problems. These boom-bust cycles should be avoided. Because loan portfolio problems often do not show up when institutions are young (many MFIs in SSA are relatively new), soundness of the sector will need to be carefully monitored.
- **Achieving and sustaining profitability:** While some institutions will continue to be government and donor subsidized, most should be moving toward self-sufficiency and profitability.

### Enterprise Financing

*In the face of stagnating private sector credit, some countries are opting to use state and development banks to promote more financing for productive sectors. Other efforts include the formation of stock markets. Both efforts may be costly.*

SSA governments in the past unsuccessfully used state and development banks to channel credit to the private sector. Given the financial losses of these institutions—with most of the banking crises caused in part by losses from development banks—during the 1990s most countries undertook to privatize these institutions and committed to refrain from direct

efforts to promote private financing. Instead, most governments see improvement in the operating framework and macroeconomic stability as the best way to enhance private sector credit.

As private sector credit stagnates, however, some countries are contemplating a more activist approach, which could be fraught with the same types of risk that they have experienced in the past (Appendix 2). Some countries, such as Gabon, are once again using development banks to channel credit to priority sectors, so far with mixed or negative results. Others, such as WAEMU member countries, are forming state-owned specialized banks to give certain sectors access to desired types of finance. In many countries, export credit agencies are subsidizing access. There is as yet no systematic review of these efforts, but it already appears that past problems are likely to reemerge.

The stock markets that were opened in a number of countries to support access to finance remain small. Up to 1989, there were just five stock markets in SSA; now there are 15. Most recently, stock markets have been established in Malawi, Swaziland, and Uganda. There is some empirical evidence that stock markets have helped listed companies to acquire finance. However, because few companies are listed and there is limited share turnover, stock markets remain largely a sideshow in SSA. High costs and a lack of supporting infrastructure are also a concern (Box 7).

### Nonbank Financial Institutions

*NBFIs are a broad group of institutions, some of which could be successful in the African context.*

NBFIs in SSA are a diverse group with the potential to increase the products and services available. They include insurance companies, pension funds, mortgage finance, consumer credit companies, finance and leasing companies, and postal savings banks. NBFIs provide products and services that banks either cannot or are not allowed to offer and could deliver other savings, investment, and risk management tools. Some NBFIs could promote lending products that are better suited to the legal and institutional setting in SSA countries than those products offered by traditional banks. For example, where collateral is inadequate, leasing may provide a lower-risk alternative for the lender than bank financing. The development of

**Box 7. Stock Markets in Sub-Saharan Africa: Critical Issues and Challenges**

Fifteen SSA countries have stock markets, most of them established over the past decade (see the table). The value and role of stock markets in financing industry has been debated in advanced as well as developing countries. While advocates point to the need for long-term finance, others fear that generally weak regulation will hinder market efficiency and the value of price signals in allocating investment resources.

Stock markets in Africa remain immature. Except in South Africa and Zimbabwe, average market capitalization is about 27 percent of GDP; it is as low as 1.4 percent in Uganda. This contrasts with emerging markets like Malaysia, which has a capitalization ratio of about 161 percent. Market liquidity is also very low: turnover ratios are as little as 0.02 percent in Swaziland compared with about 29 percent in Mexico. Low liquidity

**Sub-Saharan Africa: Indicators of Stock Market Development, 2004**

	Number of Listed Companies	Market Capitalization (percent of GDP)	Value Traded (percent of GDP)	Turnover (percent)
Botswana	18	29.4	0.6	2.1
Côte d'Ivoire	39	13.6	0.3	2.5
Ghana	29	30.7	0.8	3.2
Kenya	47	24.9	2.1	8.0
Malawi	8	9.0	1.0	11.1
Mauritius	41	39.3	1.6	4.4
Namibia	13	8.1	0.3	4.7
Nigeria	207	20.1	2.3	13.9
South Africa	403	214.1	76.5	45.0
Swaziland	6	9.3	0.0	0.0
Tanzania	6	6.2	0.2	2.5
Uganda	5	1.4	0.0	0.2
Zambia	11	8.0	0.1	1.1
Zimbabwe	79	87.9	14.0	3.9
Egypt	792	51.3	7.5	17.1
Malaysia	962	161.3	50.8	33.4
Mexico	152	25.4	6.3	29.1
Thailand	465	70.6	66.7	93.8

Source: World Bank, *World Development Indicators*.

this sector could also increase competition among banks, which could improve access to finance. As with state banks and other state-sponsored institutions, however, it is questionable if—beyond providing a legal and operating framework—there is a role for governments to sponsor such institutions.

**Improving the Operating Environment**

*In spite of the liberalization and modernization of laws and rules, financial sectors continue to suffer from uneven implementation of the legal framework.*

Many countries are trying, with varying success, to improve the operating environment of the financial sector. Legal changes, such as the modernization of central bank and banking laws, allow for more market-based interactions. Changes in business law, including bankruptcy laws, are also crucial for the operation of financial markets. In 1993, in an effort to modernize business law, a group of 16 African countries implemented the Organization for the Harmonization of Business Law in Africa (OHADA), which has already standardized a wide range of commercial laws.<sup>40</sup> There have also been broader efforts to deregulate

<sup>40</sup>These include general commercial law, corporate law and

implies greater difficulty in supporting a local market with its own trading system, market analysis, and brokers, because of the low business volume. In most SSA stock markets, informational and disclosure deficiencies prevent trading in most listed stocks. Further, supervision by regulatory authorities is often inadequate.

Stock markets in SSA have contributed to financing for listed companies but there is no evidence yet of broader economic benefits. Corporate financing patterns in certain SSA countries suggest that stock markets are an important source of finance (Yartey, 2005). In Ghana, the stock market financed about 28 percent of total asset growth of listed companies between 1995–2002, 16 percent in South Africa between 1996–2000, and 8 percent in Zimbabwe between 1995–99. In all three countries, the stock markets were for these companies the single most important source of long-term finance. However, it remains unclear whether these economies have benefited through, for example, greater savings and investment or increased investment productivity. Finally, to date all SSA stock markets remain dependent on regional government subsidies for their operation.

The literature suggests that the following preconditions are necessary if countries are to benefit from stock market development, some of which are lacking in some SSA countries:

- *Sound macroeconomic environments and sufficiently high income levels.* Income levels, domestic savings, and investment are important determinants

of stock market development in emerging markets (Garcia and Liu, 1999).

- *Appropriate sequencing.* Stock markets should follow after financial sectors have reached a certain depth. Yartey (2006) finds that a percentage point increase in financial sector development increases stock market development in SSA by 0.6 percentage point, controlling for macroeconomic stability, economic development, and the quality of legal and political institutions.
- *Transparent and accountable institutions.* Good-quality institutions, law and order, democratic accountability, and limited corruption are also important determinants of stock market development. These factors reduce political risk and enhance the viability of external finance.

SSA stock markets now face the challenge of regionalization and need better technical and institutional development. While analysts have argued for regionalization in SSA as a way to overcome small market size, there are important preconditions for successful regional approaches, such as legal harmonization (bankruptcy and accounting laws) and a liberalized trade regime. Robust electronic trading systems and central depository systems will also be important. Other financial sector reforms—steps to improve the legal and accounting framework, private sector credit evaluation capabilities, and public sector regulatory oversight—would also be beneficial.

late financial sectors, though restrictions remain in many countries on interest rates, foreign bank entry, and capital flows.<sup>41</sup>

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rules for joint ventures, laws on secured transactions (guarantees and collateral), debt enforcement law, bankruptcy law, arbitration law, accounting law, and contract laws for the carriage of goods by road. Harmonization is also under way for labor and consumer sales law.

<sup>41</sup>Capital account restrictions in SSA are complex. An average of indicators for controls on 13 types of capital transactions (where a value of 1 indicated a control) was equal to 0.8 for SSA in 1995–99 and 0.75 in 2000–04, compared with 0.71 and 0.7 for low-middle-income countries outside SSA for the same periods.

Surveys indicate that the operating environment is a major cause for concern. In spite of improvements in many laws and rules, FSAP surveys support findings from the *Doing Business* indicators that implementation of rules and regulations is uneven within countries and regions, and that there are persistent transparency and governance issues. Distortions continue to arise from official or officially sanctioned actions—such as limited access to foreign exchange, interference with interest rates, and other impediments to the operation of markets.

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The global averages for these periods are 0.66 and 0.63, respectively (data from IMF, 2005a).



## Elements of a Forward-Looking Reform Strategy

**A**frica needs better financial sectors to provide the population with services and help achieve higher growth. Renewed reform efforts should depart from lessons learned in earlier reform rounds and focus as a priority on the identified key bottlenecks.

Financial sectors need to be a reform priority for SSA. At present, they neither support economic development nor improve the quality of services available to the poor. Against the background of increasing empirical and survey evidence linking finance and growth, and the identification in many SSA countries of access limits as important obstacles to the expansion of firms, financial sector reform is one of the keys to progress on growth in SSA.

While research on how best to address financial sector challenges is still under review, reforms should be directed to key obstacles. By now, there is considerable evidence on common bottlenecks as well as lessons learned from earlier reform efforts. Renewed reforms should first focus on obstacles identified in numerous studies and seek to improve implementation of reforms based on lessons from the past. While important issues will apply to all countries, financial sector reforms should acknowledge country-specific factors, such as an individual country's level of development.

The following key priorities are proposed:

- *Eliminate distortions.* While banks on average are profitable, more dynamic development of the banking sector is hampered by manifold restrictions and supervisory forbearance. Remain-

ing important restrictions are interest rate controls and the excessive use of costly regulatory monetary instruments, such as high reserve requirements. Eliminating or reducing such restrictions could spur development of the banking sector. Similarly, an end to supervisory forbearance would allow better pricing of risk and facilitate interbank relations.

- *Increase market size.* Empirical evidence finds high costs for financial market development from small market size. At least 14 African countries belong to monetary unions and would benefit from financial integration. Other countries would benefit from a harmonized approach to regulation in the context of low restrictions to market entry, to allow financial firms to benefit from economies of scale and scope.
- *Promote a prudential framework in line with economic structures.* Prudential frameworks have been developed for more diversified economies. In SSA, some prudential rules, such as the ones on risk diversification, are routinely violated, and others, such as minimum capital levels and zero risk weights for government debt, may not be appropriate for the different levels of risk. In the context of efforts to review the appropriateness of the prudential framework, and with many SSA countries considering Basel II, this may be an opportune time to revise the prudential framework for LICs more broadly. SSA countries should be active in international forums discussing such issues.

- *Use alternative instruments to overcome bottlenecks.* Property rights issues are likely to take some time to address. Meanwhile, countries could benefit from using alternative instruments (e.g., leasing) or alternatives to collateralization (e.g., group guarantees, reversible equity stakes) that have been adopted in other regions facing similar obstacles.
- *Avoid specialized state-owned institutions.* Official efforts to promote access have so far not been successful. Any new efforts to widen the range of institutions and instruments on offer should be guided by the need to maximize the role of markets, minimize costs, and avoid distortions from interventions. Such interventions (state-owned development banks, subsidized financial instruments) should be time limited, and the government should have a clear exit strategy.
- *Apply the legal and regulatory framework evenhandedly.* Improved governance of the economy must be supported by an even-handed application of the legal framework, which is more likely if there are commercial courts and perhaps specialized judges. Differences in commercial law and practices among those countries that already have harmonized their laws should be reviewed regularly and, if necessary, amended.



## Earlier Financial Sector Liberalization Efforts

The initial focus of financial sector reform efforts beginning in the mid-1980s was liberalization of interest rates and credit allocation.<sup>1</sup> SSA entered the 1980s with financial sectors subject to heavy government intervention. For instance, in Nigeria the central bank stipulated the amount of loans and advances each commercial bank should make to each of 16 different priority sectors, as well as maximum interest ceilings for agricultural and other priority areas. While controls on credit allocation were lifted, other methods to direct credit—development banks and political interference that steered lending to public enterprises—often remained in existence. Rigid interest rate controls were gradually loosened, although sometimes in a stop-start fashion, and a number of countries retained minimum deposit or lending rates. In several countries (Zambia and Zimbabwe, for example) premature interest rate liberalization in the context of high fiscal deficits and low credibility of reforms complicated macroeconomic stabilization (Adam, 1995).

Early attempts at restructuring weak banks were often faltering. As portfolio rationalization rather than operational improvements was emphasized, problems tended to recur. A cluster of banking crises in the late 1980s triggered significant supervisory reforms, notably for member countries in the two CFA subzones, for each of which a single supervisory institution was formed. Non-CFA coun-

tries gradually shifted powers of regulation and supervision solely to central banks, whereas previously they had been shared between central banks and government ministries. In a few countries, including Nigeria, while entry regimes were liberalized, the rapid new entry of many banks in insufficiently regulated environments led to systemic soundness problems.

In the 1990s, a new emphasis was put on liberalization of exchange transactions on the current account. Banking activity was often geared toward foreign exchange trading rather than domestic financial intermediation as foreign exchange allocations were granted only to banks. Liberalizations replaced a system of administrative allocations of foreign exchange at fixed multiple exchange rate tiers. Reforms led to progress in creating functioning spot markets for many currencies in flexible exchange rate countries, and contributed to dramatic reductions in black market premiums. However, with remaining government restrictions and limited inter-bank markets, foreign exchange markets remained shallow.

Many countries began moving to indirect instruments of monetary control in the 1990s. Until then, policy had relied on bank-by-bank credit ceilings and administered interest rates. The introduction of more market-oriented monetary policy instruments and the liberalization of interest rates together with a reduction in inflation helped most countries to establish positive real interest rates. However, bond markets remained dominated by the government, primary dealers, and banks, with embryonic or virtu-

<sup>1</sup>Mehran and others (1998) present a comprehensive assessment of the progress on financial sector reforms up to the 1990s.

ally nonexistent secondary market trading. In addition to structural constraints, secondary market development was hampered by countries' reliance on liquid asset ratios, as well as a lack of commitment to market-based funding of government deficits.

By the late 1990s, most countries had made progress on strengthening banking supervision, and on bank privatization. Prudential regulations were brought more in line with the Basel Core Principles, and monitoring and inspections were instituted although weaknesses in implementation remain. While subject to frequent stops and starts, many state-owned commercial banks were eventually privatized, although the privatization process for development banks has been more problematic. In many countries, privatization brought increased foreign entry to SSA banking systems, given the concern

that banks be run by owners with strong capacity and capital, which was often lacking in local systems.

While eliminating a number of key distortions, the earlier generation of financial liberalization efforts left a large unfinished agenda. Initiation of reforms in environments of macroeconomic instability and inappropriate sequencing partly explain the limited impact these reforms had on financial deepening, savings and investment (Reinhart and Tokatlidis, 2003; Niskanke and Aryeetey, 1998). In addition, many areas were not addressed by the reforms: financial market infrastructure, coordination of fiscal and monetary policies, financial market structures, and the legal and regulatory framework, for example. Continued challenges for promoting sound, deep and efficient financial sectors in SSA are discussed in the main text.



## Development Banks and Specialized State-Owned Financial Institutions

**D**evelopment finance institutions (DFIs) emerged in SSA as part of the generally interventionist policies in the financial sector following independence. A DFI is defined here as a publicly owned financial institution with a sectoral, project, or client specialization that is judged by the government as not being met by commercial banks but necessary for developmental objectives. These institutions have had three broad lending objectives: large long-term projects such as infrastructure, enterprises not served by commercial banks (usually small and medium enterprises), and agricultural and rural areas. The establishment of DFIs was based on the rationale that these segments would not be well served by private sector finance. As DFIs were viewed as sectoral interventions, sectoral ministries were charged with bank supervision rather than central banks or ministries of finance, resulting in inherent tension between the government's operational and supervisory responsibilities.

Financial structures reliant on government or donor capital were linked to continued operation of weak institutions, and protracted restructuring efforts. While *development banks* (non-deposit-taking public lenders, a specific type of DFI) are financed through capital markets or official funds, even deposit-taking DFIs could only function with a large subsidy element. Because of this funding, DFIs undertook limited domestic financial intermediation, and were not faced with the discipline of competition for or the threat of withdrawal of deposits. As long as governments or donors were willing to inject capital, weak institutions could continue to operate.

Thus, restructuring efforts were often extended over many years. A typical pattern for restructuring has been consolidation of troubled assets into a specialized agency followed by renewed operations—but then recurrence of the same problems. For instance, Uganda Development Bank Limited (UDBL) experienced years of chronic losses and is still trying to emerge from a restructuring that began in 1997.

DFIs in SSA have been marked by a cycle of proliferation of institutions, which diluted capacity, followed by consolidation, which blurred objectives. Separate institutions for each type of priority lending were usually established, stretching regulatory and supervisory capacity.<sup>1</sup> Attrition due to inactivity and failure mitigated the problem, but consolidation programs have often been substitutes for more thorough restructuring of weak institutions. In Nigeria, for example, the merger of several weak development banks created an institution with an extremely broad but ill-defined mandate for agricultural and rural financial development, which inherited severe balance sheet problems from its constituent institutions.

<sup>1</sup>For example, until recently Kenya had six development financial intermediaries—two development banks and four DFIs, with significant overlap of functions and all with NPL rates over 50 percent. Malawi had an Industrial Development Bank (IDB for industry and agriculture), the Malawi Development Corporation (a holding company), the Agricultural Development and Marketing Corporation (smallholder agriculture), and the Small Enterprise Development Organization, in addition to a funding subsidiary of the IDB. All of these institutions were heavily dependent on donor funding.

Development banks have either exhibited chronic weakness or evolved into quasi-commercial banks. Their track record is marked by political interference in lending, high levels of NPLs, large losses often ultimately absorbed by the government, and protracted restructuring efforts. The mandate of many development banks are projects containing features of public goods, externalities, or inter-linked gains that are difficult to profitably capture. But they often end up in competition for the same clients as commercial banks, likely because their mandate is so difficult to implement. For instance, the Banque Gabonaise de Développement, while formally a development bank, has a portfolio heavily concentrated in consumer credit or secured credit to enterprises; its objective to lend to SMEs forms only a small (but increasing) part of its portfolio. However, the other DFI in the country, Banque Nationale de Credit Rurale, suffered from chronic undercapitalization and NPL problems, without ever meeting its objective of lending to rural areas. In Uganda, one DFI was active and profitable, mainly due to taking on activities where the rationale for government involvement was unclear (e.g. equipment leasing).<sup>2</sup> In Nigeria, selected

<sup>2</sup>It has recently been privatized, though a minority government stake holding remains.

development banks have ended up pursuing commercial niches.<sup>3</sup>

Nevertheless, responding to continued perceptions of underserved credit markets, new initiatives in development finance are frequent. For instance, Ghana's Agricultural Development Bank recently set up a new credit facility to boost agriculture production in four selected crop sectors. However similar efforts in the country's northern cotton sector had seen very high non-repayment rates. Angola has launched a new institution, the Development Bank of Angola, to specialize in lending to SMEs, replacing an earlier initiative that was largely unsuccessful. Contrary to long-standing plans of privatizing the Tanzania Investment Bank, the government has recently announced its transformation into a development bank geared to lending to SMEs and medium- and long-term investment projects. In addition, some existing development banks are seeking larger roles in microfinance. As there does not seem to be any improvement in the design of these institutions, it seems likely that they may experience similar problems as in the past.

<sup>3</sup>Brownbridge and Harvey (1998) argue that the presence of a development bank often acted as an unintended safeguard for commercial banks, as the most severe lending distortions were concentrated at the development bank, mitigating the need for direct government intervention in the operations of commercial banks.

## Structure and Characteristics

This appendix provides additional background on the structure of the financial sector in sub-Saharan Africa and on the characteristics of institutions and of the operating environment.

- Financial sectors in low-income SSA are small, and dominated by banks. While financial depth and access to financial services is low, soundness has improved. Financial sectors in the non-oil middle-income SSA countries are significantly deeper and sounder, and provide their populations with greater access (Table A1).
- Empirical studies have found that countries with better-functioning financial systems grow faster. The finance-growth link has also been documented in studies focused on SSA (Allen and Ndikumana, 2000; Gelbard and Leite, 1999). Among SSA countries other than oil producers, the economies that grew the fastest between 1960 and 2004 are those that are the most financially developed (Figure A1).
- A wider range of institutions could foster greater financial market efficiency and increase

TABLE A1  
Sub-Saharan Africa: Financial Indicators, 2004

	Number of Commercial Banks	M2/GDP (percent)	Bank Assets/GDP (percent)	Private Sector Credit/GDP (percent)	Central Government Credit/GDP (percent)	Capital Adequacy Ratio (percent)	Population with Formal Bank Account (percent)
Angola	16	15.0	24.1	4.3	1.9	19.6	2.0
Benin	9	23.5	...	14.1	1.0	...	...
Botswana	10	30.2	37.0	17.7	...	20.6	47.0
Burkina Faso	8	21.7	...	13.1	1.2	...	2.7
Burundi	8	26.9	...	21.5	0.9	20.2	...
Cameroon	10	17.3	18.7	8.8	1.7	8.3	3.7
Cape Verde	4	74.6	86.0	34.9	22.5	13.3	...
Central African Rep.	3	16.0	8.8	6.5	1.0	...	0.8
Chad	7	8.5	10.0	3.3	0.8	...	0.4
Comoros	1	22.1	19.0	...	0.4	...	5.0
Congo, Dem. Rep. of	9	8.3	8.0	...	1.1	...	...
Congo, Rep. of	4	14.6	8.9	3.2	0.9	3.7	2.7
Côte d'Ivoire	16	23.6	...	13.8	3.6	...	...
Equatorial Guinea	4	8.8	9.6	...	0.2	...	2.7
Eritrea	2	153.3	171.0	...	51.0	...	...
Ethiopia	9	57.4	84.3	21.0	12.7	12.3	...
Gabon	6	17.3	22.1	9.3	2.6	17.8	16.0
Gambia, The	7	45.1	55.6	12.9	9.7	8.0	...
Ghana	9	32.1	27.3	11.6	8.9	9.3	5.0

TABLE A I  
(concluded)

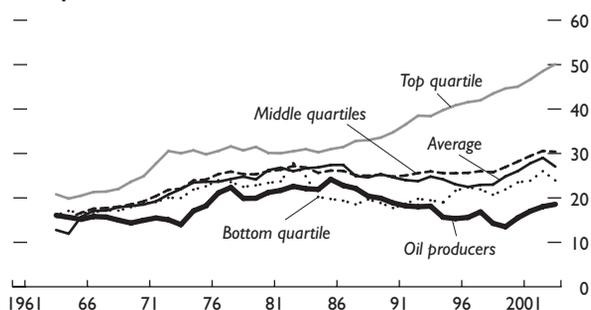
	Number of Commercial Banks	M2/GDP (percent)	Bank Assets/GDP (percent)	Private Sector Credit/GDP (percent)	Central Government Credit/GDP (percent)	Capital Adequacy Ratio (percent)	Population with Formal Bank Account (percent)
Guinea	7	16.9	14.1	...	3.8	20.6	...
Guinea-Bissau	1	30.5	9.3	1.7	0.5	...	...
Kenya	43	39.0	38.5	23.5	10.1	16.5	10.0
Lesotho	4	25.8	37.0	5.6	8.3	...	17.0
Liberia	3	...	26.4	...	...	...	...
Madagascar	7	24.4	24.5	8.5	4.0	12.0	1.4
Malawi	10	22.7	32.5	5.7	5.3	23.0	...
Mali	10	29.4	30.1	19.0	0.6	8.0	...
Mauritius	10	89.7	...	56.4	21.6	14.3	...
Mozambique	13	25.3	...	1.9	5.0	14.0	...
Namibia	4	40.0	61.9	42.7	5.0	14.8	28.4
Niger	7	14.3	9.3	5.6	0.6	...	...
Nigeria	90	23.6	45.0	13.7	5.0	—	9.6
Rwanda	6	18.2	18.2	9.8	1.5	18.3	7.0
São Tomé and Príncipe	6	49.2	66.4	...	...	...	18.7
Senegal	12	35.5	...	20.3	1.7	11.5	...
Seychelles	6	110.9	143.8	28.0	78.9	18.0	...
Sierra Leone	7	19.1	...	3.9	4.8	38.1	...
South Africa	35	66.5	109.0	79.9	6.8	13.3	46.0
Swaziland	4	21.0	26.5	17.3	2.0	...	35.3
Tanzania	21	23.1	23.0	7.5	2.6	21.2	5.0
Togo	3	28.6	...	15.9	1.4	...	...
Uganda	15	20.5	22.1	5.9	6.8	20.6	6.3
Zambia	15	21.8	26.9	6.5	7.0	0.0	...
Zimbabwe	12	38.8	85.9	21.7	7.8	35.7	17.4
SSA	30	42.7	67.4	39.5	6.1	12.6	26.8
SSA MIC	30	59.9	96.0	70.2	6.7	14.0	41.2
SSA LIC	30	27.6	38.3	12.3	5.5	11.2	7.6
Oil-exporting countries	53	20.0	33.6	11.1	3.5	4.9	7.1
Oil-importing countries	23	49.4	77.5	47.6	6.8	14.7	33.9
CFA countries	9	20.4	16.1	11.8	1.5	9.8	3.9
Non-CFA countries	34	46.5	72.5	44.0	6.8	12.8	29.2

Sources: IMF, African Department Financial Sector Profiles, and *International Financial Statistics*; Beck, Deming-Kunt, and Peria (2005); and Claessens (2005).

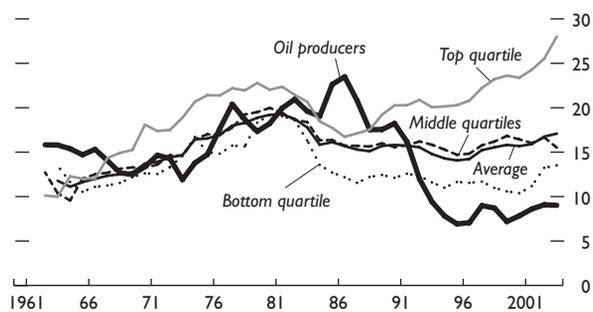
Note: Where 2004 data are not available, the nearest available data are used. The averages are calculated using PPP-adjusted GDP weights.

FIGURE A I  
Financial Development of Countries Classified by Growth  
(Percent)

**A. Liquid Liabilities as a Share of GDP**



**B. Ratio of Private Sector Credit to GDP**



Source: IMF, World Economic Outlook database, 2004.

Note: The six oil-producing countries are classified separately. The remaining countries are classified by quartiles according to real growth over 1960–2003.

TABLE A2

**Structure of Nonbank Financial Institutions, 2004**

	Insurance Companies			Pension Funds			Other NBFIs		
	Number	Assets as percent of		Number	Assets as percent of		Number	Assets as percent of	
		Total financial assets	GDP		Total financial assets	GDP		Total financial assets	GDP
Botswana	13	1.6	1.5	139	17.4	16.1	8	34.3	31.7
Ethiopia	8	1.5	1.4	1	1.5	1.4	1,050	3.0	2.9
Gabon	6	7.1	1.9	1	...	1.1	8	4.9	1.3
Ghana	18	2.0	1.1	1	15.1	8.1	286	6.0	3.2
Kenya	44	8.2	6.8	781	...	13.2	2,689	15.0	12.6
Nigeria	118	2.1	...	9	0.6	...	502	8.1	...
Rwanda	4	4.3	1.5	1	20.6	7.1	5	7.1	2.4
Seychelles	2	2.1	3.4	1	5.0	8.3	3	5.8	9.6
Tanzania	14	4.0	1.0	3	13.0	4.0	...	...	...
Uganda	19	...	0.8	2	...	2.5	83	...	0.3
Zambia	8	3.5	1.6	190	16.7	7.0	42	23.1	9.7
Zimbabwe	23	3.6	4.1	28	2.0	2.3	171	10.2	11.4

Source: IMF, Financial Sector Profiles.

TABLE A3

**CFA Franc Zone: Interbank Market Transaction Volumes**

(Monthly average, in billions of CFA francs)

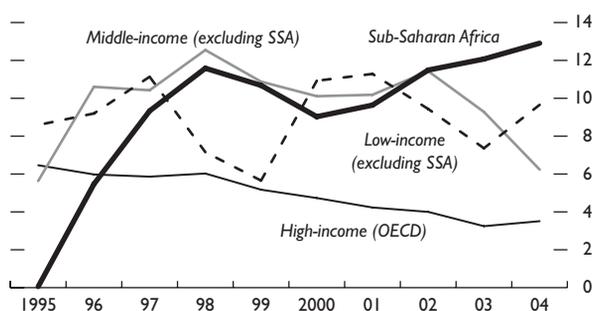
	CFA Franc Zone: Interbank Markets									
	1997	1998	1999	2000	2001	2002	2003	2004	2005	
WAEMU	105.6	152.4	199.6	155.6	126.8	105.6	52.8	48.0	66.0	
CEMAC	3.9	19.4	21.2	14.7	23.6	13.1	9.2	7.5	...	

Sources: Banque Central des États de l'Afrique de l'Ouest (BCEAO—Central Bank of West African States) and Banque des États de l'Afrique Centrale (BEAC—Bank of Central African States).

the products and services available. While the nonbank financial institution (NBFi) sector is small, it is growing in importance in SSA. In a few countries, the asset size of insurance companies, pension funds and other NBFIs is sizable compared to total financial system assets (Table A2).

- Interbank activity is limited in most SSA countries. For example, evidence from interbank money markets in WAEMU and CEMAC illustrates the minimal development of these markets (Table A3).
- High real lending interest rates are a major impediment to increased lending. Lending rates in SSA are among the highest in the world (Figure A2).

FIGURE A2  
**Sub-Saharan Africa and Comparator Groups:  
Real Lending Rates in Sub-Saharan Africa  
versus Rest of the World**  
(Percent)



Source: IMF, International Financial Statistics.

## Soundness and Performance

This appendix provides additional information on the soundness and economic performance of financial sectors in sub-Saharan Africa.

- Bank soundness has improved since the early 1990s, and SSA banks now exhibit similar levels of basic soundness as in other low-income countries. While banks in low-income SSA

have a larger share of problem loans in total assets than in other low-income countries, capital ratios and provisioning also tend to be higher. Among banks in low-income SSA, foreign-owned ones have the lowest problem loans, while capital ratios and provisioning are higher in public banks (Table A4).

TABLE A4

### Sub-Saharan Africa and Comparator Groups: Financial Soundness Indicators by Ownership Category

(Percent of assets)

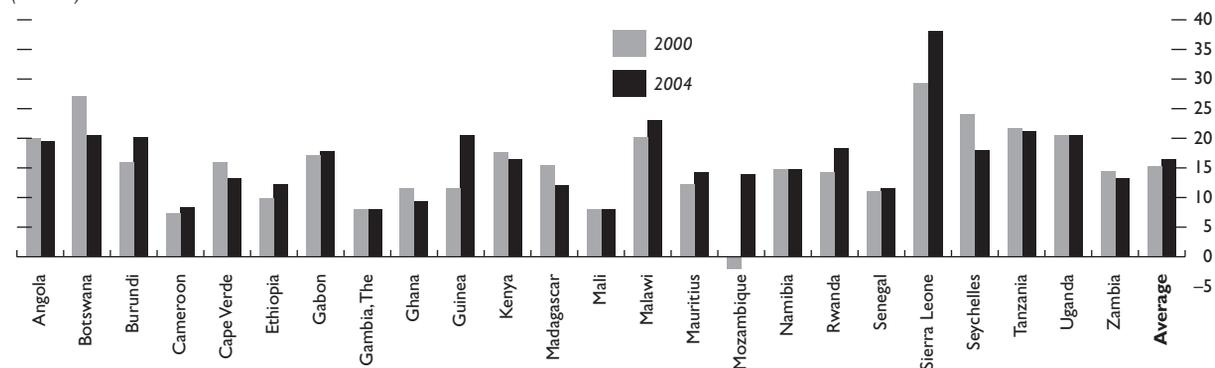
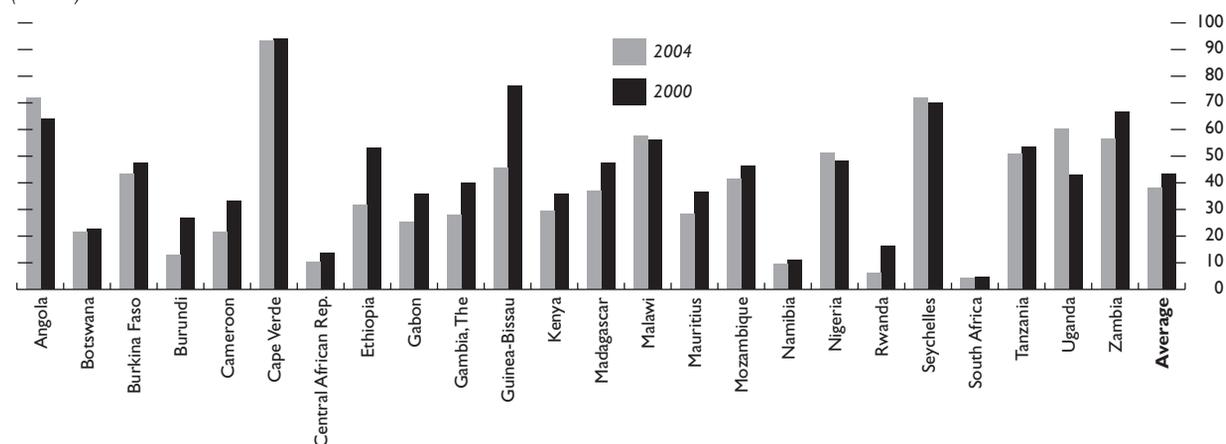
	Years	Sub-Saharan Africa	Other Low-Middle-Income (excluding SSA)	Sub-Saharan Africa Low-Income	Other Low-Income (excluding SSA)
<i>Public banks</i>					
Total problem loans	1996–99	12.2	12.8	12.8	14.4
	2000–03	10.7	15.4	15.9	14.2
Total capital	1996–99	26.4	23.6	21.5	25.5
	2000–03	33.8	31.7	38.9	25.4
Liquid assets	1996–99	28.0	27.9	30.5	33.1
	2000–03	40.3	29.6	39.7	37.2
Provisioning (percent of problem loans)	1996–99	65.0	68.0	74.8	24.2
	2000–03	84.0	31.0	58.2	28.4
<i>Domestic private banks</i>					
Total problem loans	1996–99	9.4	6.7	9.7	4.0
	2000–03	12.3	10.0	9.6	4.0
Total capital	1996–99	12.5	11.5	12.4	5.4
	2000–03	15.6	14.5	17.6	10.6
Liquid assets	1996–99	22.9	17.5	23.1	15.8
	2000–03	23.6	18.2	23.0	17.1
Provisioning (percent of problem loans)	1996–99	38.3	70.0	36.7	...
	2000–03	38.6	38.3	35.5	...

TABLE A4  
(concluded)

	Years	Sub-Saharan Africa	Other Low-Middle-Income (excluding SSA)	Sub-Saharan Africa Low-Income	Other Low-Income (excluding SSA)
<i>Foreign banks</i>					
Total problem loans	1996–99	7.8	7.5	7.5	...
	2000–03	5.9	4.0	6.7	...
Total capital	1996–99	16.3	7.3	20.2	8.2
	2000–03	21.3	12.1	24.6	5.1
Liquid assets	1996–99	33.2	19.8	37.5	25.4
	2000–03	36.9	23.4	40.1	24.2
Provisioning (percent of problem loans)	1996–99	50.0	50.0	51.0	27.0
	2000–03	49.5	59.0	53.3	...

Source: IMF staff calculations from bank-level data by IDB staff.

Note: In some cases, indicated by "...", the number of observations was too small to permit a meaningful calculation.

FIGURE A3  
Sub-Saharan Africa: Financial IndicatorsA. Regulatory Capital to Risk-Weighted Asset Ratios in 2000 and 2004  
(Percent)B. Liquid Assets as Ratio to Total Assets in 2000 and 2004  
(Percent)

Source: IMF, Financial Sector Profiles.

Note: When data were not available for the indicated year, the closest available year was used.

- On average banking sectors are adequately capitalized: capital adequacy ratios in most countries exceed their implemented 8 percent minimums. For SSA as a whole, CARs increased from 2000 to 2004. Capital to asset ratios vary across countries, and within countries individual banks do not meet basic adequacy tests. Average liquidity ratios (ratio of liquid assets to liquid liabilities) are very high at around 30 to 40 percent, while the range is wide: from less than 5 percent in South Africa, to over 90 percent in Cape Verde (Figure A3).
- Banking sectors in low-income SSA are less efficient than in other low-income countries and the gap is widening. Low efficiency in most banks, including foreign-owned institutions, leads to high overhead costs and high net interest margins to cover these costs (Table A5).
- Low operational efficiency of banking in SSA is not completely accounted for by poor environmental conditions such as high inflation, concentrated banking systems and corruption. While these factors are negatively associated with bank

TABLE A5

### Sub-Saharan Africa and Comparator Groups: Banking Sector Income and Costs Overall and by Ownership

(Percentage of assets)

	Net Interest Margin		Loan Loss Provisions		Overhead		Profit Before Tax	
	1996–99	2000–03	1996–99	2000–03	1996–99	2000–03	1996–99	2000–03
Sub-Saharan Africa	8.0	8.2	3.4	3.5	7.4	7.4	3.0	3.0
Other low-middle-income (excluding SSA)	7.1	6.6	5.1	3.4	7.0	7.1	0.2	1.1
Sub-Saharan Africa low-income	8.2	8.5	3.7	3.7	7.6	7.7	3.3	3.2
Other low-income (excluding SSA)	5.5	4.9	3.4	3.0	5.3	5.3	1.1	1.1
	Public Banks				Foreign Banks			
	Net interest margin		Overhead		Net interest margin		Overhead	
	1996–99	2000–03	1996–99	2000–03	1996–99	2000–03	1996–99	2000–03
Sub-Saharan Africa	8.2	7.1	7.2	7.1	10.1	9.8	7.9	7.9
Other low-middle-income (excluding SSA)	9.3	8.6	9.2	9.1	5.9	6.2	6.1	6.9
Sub-Saharan Africa low-income	10.0	9.4	9.1	9.3	10.9	10.1	8.4	8.1
Other low-income (excluding SSA)	6.4	6.4	6.7	7.3	5.2	4.1	3.6	4.2

Source: IMF staff calculations from bank-level data by IDB staff.

TABLE A6

### Determinants of Banking Sector Depth and Efficiency in Lower-Income Countries

Dependent Variable	Loans-to-GDP Ratio				Overhead Costs			
GDP per capita	3.4*	(0.07)	1.8	(0.34)	-0.2	(0.67)	0.4	(0.36)
Corruption	14.4*	(0.01)	15.2*	(0.01)	-1.0	(0.27)	-1.4	(0.11)
Inflation	-4.4*	(0.01)	-4.2*	(0.01)	0.66*	(0.03)	0.6*	(0.04)
Budget balance	0.0	(0.96)	0.2	(0.73)	0.0	(0.70)	0.0	(0.73)
Interest on public debt	0.3	(0.57)	0.7	(0.20)	-0.1	(0.60)	-0.2	(0.19)
Concentration	-19.2*	(0.01)	-16.0*	(0.01)	-2.7*	(0.06)	-3.5*	(0.01)
Sub-Saharan Africa dummy			-6.4*	(0.04)			2.1*	(0.01)
Number of observations	72		72		70		70	
R-squared	0.59		0.62		0.25		0.36	

Source: IMF staff calculations from data in Detragiache, Gupta, and Tressel (2005).

Note: P-values are in parentheses and coefficients significant at 10 percent are indicated with \*. The dependent variables are averages for 1999–2001 and the right-hand-side variables cover various periods in the 1990s; see source for details. Regressions include a dummy for transition countries. Overhead costs are expressed as a percentage of bank assets.

TABLE A7

**Sub-Saharan Africa and Comparator Groups: Banking Supervision and External Oversight**

	Sub-Saharan Africa	Other Low-Middle-Income (excluding SSA)	Sub-Saharan Low-Income	Other Low-Income (excluding SSA)
<b>Banking supervision</b>				
Official supervisory power	10.9	10.6	11.0	11.2
Prompt corrective power	2.0	3.1	2.2	4.1
Discretionary forbearance	1.9	1.0	2.0	0.9
Strength of external audit	6.1	5.8	6.3	6.0
<b>External oversight of banking systems</b>				
Financial statement transparency	4.6	4.4	4.7	4.4
Accounting practices	0.9	0.8	0.9	0.9
External ratings and credit monitoring	1.0	1.6	1.0	1.6
Private monitoring index	7.4	7.0	7.4	6.4
External governance index	13.3	12.4	13.5	12.6

Source: IMF staff calculations from indices in Barth, Caprio, and Levine (2006).

ing market efficiency in cross-country regressions, efficiency of SSA banks is still lower than predicted by a model that accounts for them (Table A6).

- Cross-country surveys of banking supervision frameworks suggest that official supervisory re-

quirements are comparable to those in other low-income countries. The same is true for measures of external oversight of banking systems. The latter measures contribute to a supervisory strategy that can empower private monitoring of banks by promoting accurate information disclosure (Table A7).

APPENDIX  
**5**

## Business and Economic Environment

This appendix gives further background on the legal and economic environment in which financial sectors in sub-Saharan Africa operate.

- Poor legal and institutional frameworks create a difficult operating environment for banks. The World Bank's *Doing Business* indicators show legal framework and credit information indices that are lower than in comparator countries. The coverage of credit registries is also lower (Table A8).
- Better legal and institutional environments are associated with a higher share of private credit to GDP in SSA. The indices for the extent of credit information and the legal rights of creditors are strongly correlated with the private loan share (Table A9).
- Bank lending is also constrained by property rights systems that are weaker than in other regions. *Doing Business* surveys indicate that the costs of enforcing contracts, collecting debts, and registering property are significantly higher in SSA than in comparator groups (Figure A4).
- Private enterprises in SSA identify access to credit and the cost of financing as key obstacles to firm growth. For companies included in a

TABLE A8

### Sub-Saharan Africa and Comparator Groups: *Doing Business* Legal and Credit Indicators

(Values in 2005)

	Sub-Saharan Africa	Other Lower-Income (excluding SSA)	Sub-Saharan Low-Income	Other Low-Income (excluding SSA)
Credit-conducive legal rights index	4.3	4.6	4.4	4.4
Credit information index	1.5	2.1	1.4	1.4
Public credit registry coverage (percent of adults)	0.8	3.1	0.8	0.8
Private credit bureau coverage (percent of adults)	3.7	6.9	0.2	0.2

Source: World Bank, *Doing Business 2005* data set.

Note: The legal rights index ranges from 0 to 10; higher scores indicate that collateral and bankruptcy laws are better designed to expand access to credit. The credit information index ranges from 0 to 6; higher values indicate that more credit information is available from either a public registry or a private bureau to facilitate lending decisions. Both coverage variables reflect the number of borrowers covered by registry or bureau as a percentage of the adult population.

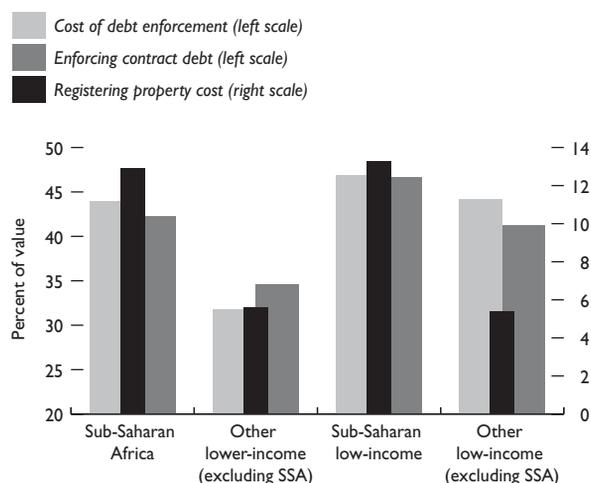
TABLE A9

**Sub-Saharan Africa: Doing Business Indicators and the Private Loan Share**

	Sub-Saharan Africa Regressions		Sub-Saharan Africa Low-Income Regressions	
	<i>Dependent variable: private loan share of GDP</i>			
Legal rights index	0.02 (0.18)	0.01 (0.56)	0.01* (0.06)	0.02* (0.03)
Credit information index	0.03* (0.06)	0.01 (0.86)	0.01 (0.80)	0.00 (0.95)
Interest rate spread	-0.01 (0.12)	-0.01* (0.05)	-0.01* (0.04)	-0.01* (0.02)
GDP per capita		0.11 (0.01)		0.03 (0.26)
R-squared	0.26	0.54	0.25	0.29

Sources: World Bank, *Doing Business 2005* data set; IMF, *International Financial Statistics*, and *World Economic Outlook*.  
 Note: Significance levels are in parentheses. Coefficients significant at 10 percent or better are indicated by \*.

**FIGURE A4**  
**Sub-Saharan Africa and Comparator Groups:**  
**Doing Business Costs of Debt and Contract**  
**Enforcement and Property Registration**



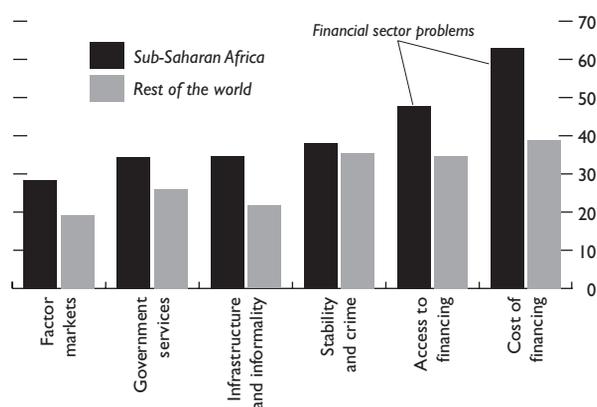
Source: World Bank, *Doing Business* database, 2006.

World Bank survey, the share of companies in SSA identifying financial sector problems as a serious growth constraint—over half—was much higher than for firms surveyed in the rest of the world (Figure A5).

- Banks in SSA have a higher propensity to allocate deposits to claims on the government than banks elsewhere. In addition, they have mobilized deposits at a slower rate than banks in comparator groups. From the second half of the 1990s to 2004, while claims on the gov-

**FIGURE A5**  
**Sub-Saharan Africa: Obstacles to Growth of Private Enterprises**

(Percent of companies indicating an obstacle as a serious constraint to growth of business)

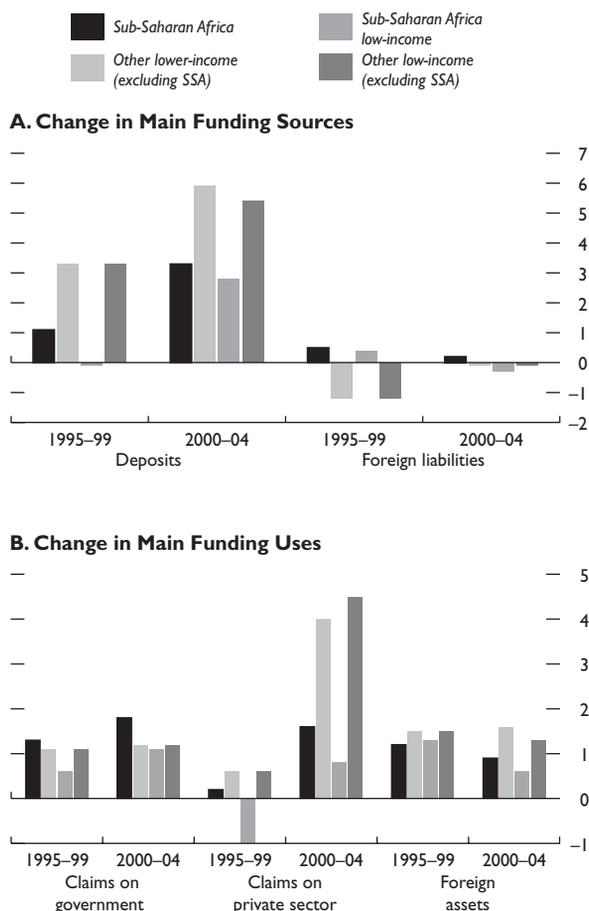


Source: World Bank, *Investment Climate Surveys*, 2005.

ernment grew faster than claims on the private sector in SSA, the pattern is strongly reversed in other LICs. In addition, reserves and foreign assets account for more of asset growth in low-income SSA than claims on the private sector (Figure A6).

- Financial sector reforms have been incorporated into IMF-supported program conditionalities. On average in SSA, while the number of financial sector conditions per program has not increased as sharply in SSA as in the rest of the world, the share of “harder” types of conditionalities (prior actions and performance criteria)

**FIGURE A6**  
**Sub-Saharan Africa and Comparator Groups:**  
**Funding Sources and Uses**  
*(Percentage change from previous four-year period)*

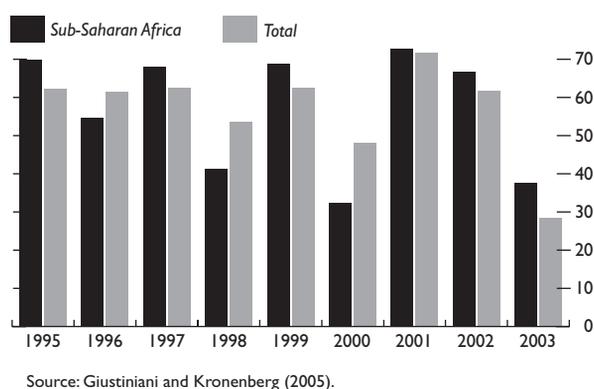


Source: IMF, *International Finance Statistics*.

have risen more than in other groups. As in the rest of the world, compliance with financial sector conditionality declined over 1995–2003 (Figures A7, A8, A9).

- A key feature of the environment for the conduct of monetary policy is a country's choice of nominal anchor. The movement of most SSA countries outside the CFA zone and the rand Common Monetary Area from an exchange rate anchor to a monetary anchor has been associated with successful stabilization of inflation in most countries (Table A10).

**FIGURE A7**  
**Financial Sector Conditionality Compliance in IMF-Supported Programs in SSA and All Countries, 1995–2003**  
*(Proportion of program measures implemented as scheduled)*



**FIGURE A8**  
**Financial Sector Conditionality Hardness in IMF-Supported Programs in SSA and All Countries, 1995–2003**  
*(Share of prior actions and performance criteria in total program measures)*

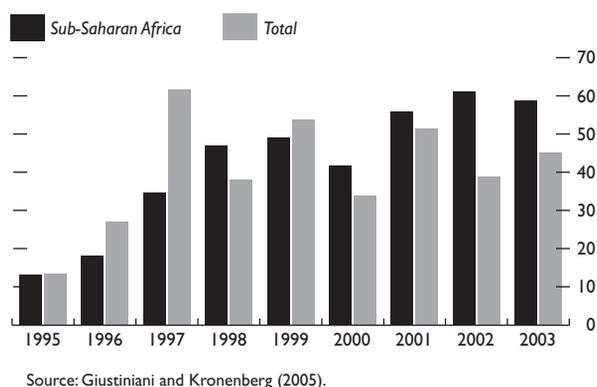
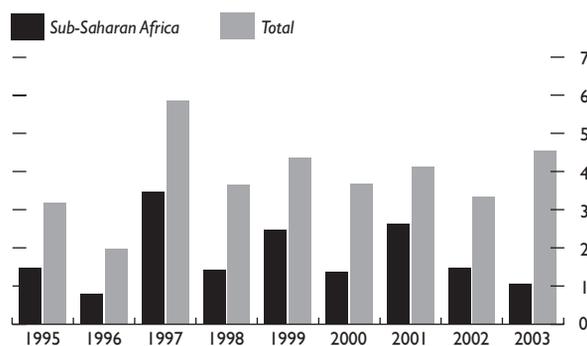


FIGURE A9  
**Financial Sector Conditionality Intensity  
 in IMF-Supported Programs in SSA and  
 All Countries, 1995–2003**  
*(Number of conditions per program year)*



Source: Giustiniani and Kronenberg (2005).

TABLE A10

**Sub-Saharan Africa: The Choice of Anchor for Inflation**

Description		Number of Countries					
		1980	1985	1990	1995	2000	2004
<b>Exchange rate anchor</b>	French franc/euro [CFA Zone]	14	14	14	14	14	14
	South African rand [CMA]	2	2	3	3	3	3
	U.S. dollar <sup>1</sup>	5	4	4	6	3	3
	Portuguese escudo	0	0	1	0	0	0
	Spanish peseta	1	0	0	0	0	0
	Pound sterling	1	1	0	0	0	0
	SDR	11	7	2	1	0	0
	Other currency composites <sup>2</sup>	5	9	10	3	2	3
<b>Monetary anchor</b>	Defined monetary aggregate target <sup>3</sup>	0	0	0	0	7	6
	Other	5	7	10	17	12	14
	Of which: IMF-supported program <sup>4</sup>	...	...	...	...	10	7
<b>Inflation anchor</b>	Inflation targeting framework	0	0	0	0	1	1
		<i>As percent of total non-CFA non-CMA countries</i>					
<b>Exchange rate anchor</b>	U.S. dollar	18	14	15	22	12	11
	Portuguese escudo	0	0	4	0	0	0
	Spanish peseta	4	0	0	0	0	0
	Pound sterling	4	4	0	0	0	0
	SDR	39	25	7	4	0	0
	Other currency composites	18	32	37	11	8	11
		83	75	63	37	20	22
	<b>Money-based anchor</b>	Monetary aggregate target	0	0	0	0	28
Other		18	25	37	63	48	52
	Of which: IMF-supported program	...	...	...	...	40	26
<b>Inflation anchor</b>		18	25	37	63	76	74
	Inflation targeting framework	0	0	0	0	4	4

Source: IMF, *Annual Report on Exchange Arrangements and Exchange Restrictions* (2004).

<sup>1</sup>Seychelles, Guinea, and Eritrea.

<sup>2</sup>Botswana, Comoros (euro), and Cape Verde (euro).

<sup>3</sup>Includes countries targeting either broad or reserve money.

<sup>4</sup>Programs typically defined in terms of NIR floor and NDA ceiling.



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