Making Finance Work for Africa – the Role of Governments in a Global World in Crisis

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Abstract: The current crisis has refocused the debate on financial sector policies in Africa. Recent progress has come under threat with the withdrawal of global financial resources and the global economic recession. Now more than ever, however, a deep, efficient and inclusive financial system is the key to economic development and poverty alleviation. To further deepen and broaden African financial system, even in the adverse current market conditions, a careful balance is needed on the role of governments and the approach towards financial globalization. This paper argues for cautious, market-friendly and context-specific government interventions into the financial markets beyond institution building and macroeconomic stabilization. While foreign bank entry has brought more benefits than costs, it is not a panacea; capital account liberalization, on the other hand, has to be handled very carefully, with the necessary macroeconomic and institutional frameworks in place. The potential of regional integration has not been exploited to its full benefit yet. The current crisis poses additional challenges, but should not discourage government from continuing in their quest to deepen and broaden financial systems, working with markets and addressing its failures, not replacing them.

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1. Introduction

While 20 years ago, financial system development was an afterthought on development economists' agenda, financial sector policies have become a center piece in the debate on how to foster growth in low-income countries and reduce stark poverty levels. Over the past 15 years, ample evidence using different aggregation levels and methodologies has been accumulated on the growth enhancing effect of financial sector development. This is not to downplay the reverse causation from economic development to deeper and more sophisticated financial systems. But even accounting for this reverse causation, research has established a robust positive impact of financial sector deepening on economic development. Figure 1 illustrates the findings of a well-established body of empirical evidence; countries with higher levels of credit to the private sector relative to GDP experienced higher average annual real GDP per capita growth rates over the period 1980 to 2003. These findings are confirmed by cross-country, panel and by time-series estimation techniques (see Levine, 2005, and Beck, 2008, for an overview). The effect of finance on growth is not only statistically, but also economically significant. To illustrate the effect of financial deepening, compare Ethiopia with Thailand. Over the period 1980 to 2003, Private Credit to GDP averaged 17% in Ethiopia, but 67% in Thailand The cross-country comparisons illustrated in Figure 1 suggest that Ethiopia's real GDP per capita would have grown 1.4 percentage faster, had it had the same level of financial development as Thailand, or 1.6% instead of the actual 0.2%. This would have resulted in 40% higher GDP per capita in 2003.[1] These results, however, do not provide us insights into the policies that foster financial deepening, which we will discuss below.

[1] Obviously, such comparisons are illustrative only, as the coefficient estimates measure marginal rather than large discrete changes.

What are the channels through which finance fosters economic growth? While countries with deeper financial systems experience faster rates of physical capital accumulation, it is mostly through improvements in resource allocation and productivity growth that finance helps economies grow faster (Beck, Levine and Loayza, 2000; Love, 2003; Wurgler, 2000). Financial deepening helps especially industries more dependent on external finance (Rajan and Zingales, 1998) and helps reduce financing constraints especially for small firms (Beck, Demirguc-Kunt and Maksimovic, 2005). Financial deepening has thus a transformative effect on economies, shaping the industrial structure, the firm size distribution and even organizational structures (Demirguc-Kunt, Love, and Maksimovic, 2006).

Who benefits most from financial deepening? Theory provides conflicting predictions whether it is the rich or the poor who benefit most from financial sector development. Some theories posit that especially at early stages of development, only the rich can afford to access and profit from financial markets so that financial development benefits the rich and thus intensifies income inequality (Greenwood and Jovanovic, 1990). Other theories, however, point to high fixed transaction and contract enforcement costs and information asymmetries that make credit constraints more binding for small and poor entrepreneurs and households (Galor and Zeira, 1993; Aghion and Bolton, 1997; Galor and Moav, 2004). Rajan and Zingales (2003) argue that vibrant financial markets "can overcome the tyranny of collateral and connections and make credit available even to the poor." From this perspective, financial development is pro-poor as it helps especially small and poor savers and borrowers.

Cross-country comparisons show a pro-poor effect of financial deepening (Beck, Demirguc-Kunt, and Levine, 2007). It is the poorest quintile who see their income share grow fastest with financial deepening. Income inequality goes down faster in economies with deeper financial systems. Given that changes in poverty levels can be decomposed into changes in income per capita and changes in income inequality, the pro-growth and pro-equity effects of finance together establish the pro-poor effect of finance. Figure 2 illustrates the pro-poor effect of finance; countries with deeper financial systems see their poverty levels drop at faster rates. As in the case of economic growth, the economic effect of financial deepening on poverty reduction is strong, as again the comparison between Ethiopia and Thailand illustrates. Specifically, the cross-country comparisons illustrated in Figure 2 suggest that instead of a reduction in the headcount from 33% to 23% over the period 1981 to 2000, a level of financial development similar to that of Thailand would have allowed a reduction of the headcount to 9% in Ethiopia.

While the pro-poor effect of finance seems to be a vindication for the micro-credit movement and Nobel Prize Winner Yunus Mohamed who sees lack of finance as the main obstacle for micro-entrepreneurs, first explorations of the channels through which finance affects income inequality and poverty levels point to an important role of indirect effects. Specifically, evidence from both the U.S. and Thailand suggests that an important effect of financial sector deepening on income inequality and poverty is an indirect one – by changing the structure of the economy and allowing more entry into the labor market of previously un- or underemployed segments of the population, finance helps reduce income inequality and poverty, but not by giving access to credit to everyone (Beck, Levine and Levkov, 2007; Gine and Townsend, 2004). It is important to stress that this is preliminary evidence to be confirmed or refuted by future research, but it has focused the debate on an important question: should policy makers focus on deepening or broadening of financial sectors? It has also helped broaden the debate on financial services for the poor beyond microcredit to other financial services, such as savings services, payment services (especially in the context of receiving remittances from family members that emigrated to other parts of the country or the world) and insurance services.[2]

While there is an increasing consciousness among policy makers and other stakeholders among African countries that deepening and broadening the financial sector is critical for increasing growth rates and reducing poverty and thus making progress towards the Millennium Development Goals, there is still significant debate about how to proceed. The controversies on financial sector reform focuses on two issues: the role of government in the financial sector and how African financial systems (and the economies in general) should adapt to increasing globalization. Debates on both issues have changed dramatically over the past decades. The approach of governments replacing markets was seen as necessary in the 1960s and 70s, changed into an almost laissez-faire approach focusing on liberalization and privatization in the 1980s and 90s, before the pendulum went back towards a more active, albeit different, role for government during the past 10 years. Similarly, the attitude towards integration into global markets has changed dramatically over the past decades, from open capital accounts being part of the Washington consensus to a more nuanced approach after the East Asian crisis, and will surely be further influenced by the on-going financial crisis.

[2] For a more in depth discussion of these issues and the relevant literature, see World Bank (2007a).

After a decade of macroeconomic and financial reforms, the shallowness of finance in Africa is worrying, especially given the potential that finance has in fostering economic growth and poverty reduction and meeting the Millennium Development Goals of halving poverty levels by 2015. Section 2 presents the current status of finance in Africa and some promising trends. Sections 3 and 4 focus on two critical areas – the role of governments in deepening and broadening financial systems in Africa and the role of globalization, i.e. the integration of Africa's financial systems into global financial markets. In this context, we will also discuss lessons from the East Asian miracle for Sub-Saharan Africa. Section 5 discusses the repercussions of the current financial crisis in the U.S. and Europe on financial sector policy in Sub-Saharan Africa, with a focus again on the two issues of government's role and globalization. Section 6 concludes and looks forward.

2. Finance in Africa – growing from a low level

Given the central importance of finance for economic development and poverty alleviation, the shallowness of African finance is alarming. African financial systems are small, both in absolute as in relative terms (Figures 3 and 4). Many African financial systems are smaller than a mid-sized bank in Continental Europe, with total assets often less than $ 1 billion. Small size is connected to low productivity and skill shortages, and prevents banks from exploiting scale economies and might deter them from undertaking large investments into technology. Africa's financial systems are also characterized by very limited outreach, with less than one in five households having access to any formal banking service, be it savings, payments or credit services (Figure 5). Again, this in stark contrast not only to Continental Europe, where access to a checking account is taken for granted, but also to other regions of the developing world.

Banking is very expensive, as reflected by high interest spreads and margins (Figure 6). This spread between deposit and lending interest rates provides dis-incentives for both savings and lending and is driven mainly by the absence of scale economies and very high risks due to weak and underdeveloped contractual frameworks and economic and political volatility. In spite of high costs and high risks, however, banks are very profitable. Indeed, subsidiaries of foreign banks in Sub-Saharan Africa have higher returns on assets and equity than subsidiaries of the same bank in other regions of the world, possibly reflecting the lack of competition in most banking markets in the region (Honohan and Beck, 2007). Banking is also very expensive for deposit customers, as reflected by very high minimum balance requirements and annual fees for checking but even savings account holders in many African countries (Beck, Demirguc-Kunt and Martinez Peria, 2008). Moreover, these high costs alone can explain why less than 20% of the population in many African countries has a bank account.

The gap between Africa and other regions of the world is even starker in other parts of the financial systems. Only a third of countries in the region have stock markets, which are mostly small and illiquid. Attempts at regional exchanges such as in Abidjan have had limited success, with most issues still coming from the host country. Corporate bond markets are almost non-existing in most countries, with many countries even having very shallow government bond markets if at all (IMF, 2008).

While the low levels of financial depth and breadth partly reflect low levels of economic development and the small size of countries, the prevalence of informal economic arrangements, high exposure to economic and socio-political shocks and low levels of governance, as reflected in limited rule of law, lack of democratic participation and inefficient bureaucracies, also contribute to the financial shallowness (Honohan and Beck, 2007). More specifically, the informality of the personal and professional situation of many households and micro-entrepreneurs prevents them not only from opening bank accounts as they do not possess the necessary documents, but also excludes them from the formal credit market, in the absence of formal title to their land or even just a formal enterprise registration. Volatile income and revenues streams that often come with informality are further barriers to access to formal credit. The prevalence of economic and socio-political shocks in most African countries limits the time horizon of savers and investors alike and can partly explain why a large proportion of African savings is still held outside the continent. Weaknesses in the contractual framework, high degrees of corruption, the risk of expropriation and inefficient bureaucracies are different dimensions of the deficient governance structure in most countries of the region, but all with the same consequence of limited intermediation and focus on short-term transactions rather than long-term commitments. Taken together, the factors can explain why the level of financial development in many low-income countries in Africa is lower than low-income countries in other regions and has not fulfilled its growth potential yet (Figures 1 and 7), although this has been improving compared to previous years (Honohan and Beck, 2007).

However, many countries in Sub-Saharan Africa have not only seen economic growth pick up in recent years, but also financial deepening and broadening. While this might be partly demand driven, partly by international capital inflows, improvements in the institutional framework of finance, such as the establishment of Commercial Courts and Alternative Dispute Resolution systems, establishment or improvements of collateral registries and credit reference bureaus, and macroeconomic stability have certainly contributed to this improvement. Technological advances have allowed Sub-Saharan Africa to leap-frog, as for example in utilizing cell phone technology for expanding the share of population having access to payment services. Stronger confidence in Africa's financial systems is also reflected in private capital inflows quintupling over the period 2000 to 2007 (IMF, 2008) and surpassing donor inflows for the first time in 2006, thus reversing a long-term trend. This surge of private capital inflow into Africa was part of increased capital flows to emerging markets given the worldwide liquidity glut. However, as cross-country comparisons show (IMF, 2008), these flows partly also reflect improved macroeconomic fundamentals in many African countries, such as macroeconomic stability and fiscal discipline. When looking behind this aggregate, however, one notes that capital flows are concentrated in specific countries and sectors, such as natural resource extraction, thus benefiting narrow parts of the economy and society.

While the direct impact of the current crisis in the U.S. and Europe on African financial systems is more contained – given that they are not as closely integrated in the global financial system as other regions of the developing world and hold most of their assets and commitment on rather than off-balance sheet – indirect effects through the real economy and through reduced private capital inflows due to reduced risk appetite might very well have negative repercussions for further deepening of finance in Africa. It is thus even more important to emphasize the necessary foundations to solidify and deepen the progress already made in financial system development in Africa, even in these adverse times. It is also important to draw the correct lessons from the current turmoil in international financial markets as we will discuss in more depth further below.

Four striking characteristics of African financial systems, already discussed above, make the debate on the role of governments and integration into global financial markets more challenging, but also more critical (Honohan and Beck, 2007). The small size of most African financial systems and their host economies makes integration – be it regional or global – more pressing to reap benefits of scale economies. At the same time, the small size reduces the scope for arms-length relationships within the economy and thus underlines the need for appropriate governance structures for government interventions in the financial system. The high exposure to economic shocks might call for a stronger role of governments, while at the same time reducing the horizon over which stakeholders including governments can plan. The high incidence of informality makes government interventions less effective as large shares of the population might not be affected by them. On the other hand, the incidence of informality calls for intervention that focus on bringing larger parts of the population into the formal economy, such as through lowering the registration costs for new businesses or the documentation requirements in the formal financial system. Finally, the governance deficiencies discussed above put certain limits to the effectiveness of government interventions and to the extent to which countries can benefit from globalization. Direct government interventions are more likely to be captured by special interest groups in societies with governance deficiencies; governance deficiencies typically prevent long-term investments and thus limit the gains from international trade (Freund and Bolaky, 2008).

It is important to note, however, that financial deepening and broadening can contribute to reducing these four pervasive characteristics of Sub-Saharan African economies and their impact on economy and society. Financial deepening and broadening can transform societies towards more formal economies, as the example of Thailand has shown (Gine and Townsend, 2004). Effective financial systems can reduce the effects of macro-level (Bacchetta and Caminal, 1996) and micro-level shocks, the latter through products such as micro-insurance (Gine, Townsend and Vickery, 2008). Financial sector reforms can also be a powerful tool in improving governance, be it through the establishment or reform of the necessary institutional framework, such as Commercial Courts or credit registries, be it through improved financial disclosure, or be it through positive example of governance reform, such as successful privatization. Introducing a credit registry can limit the degree to which politicians and other connected individuals have access to preferred credit without having to repay it (as can be inferred from the typical resistance of parliamentarians against such institutions). Breaking the links between government-owned banks and privileged borrower groups can create a level playing field among enterprises and foster competition.

The next two sections will discuss the role of government and the integration into the international financial markets, respectively. We will draw on the existing literature, experiences across Africa and experiences from other developing regions of the world – especially East Asia - to discuss the proper role of government and the adequate reaction to the trends towards globalization.

3. The Role of Government in the financial sector

This section discusses the historical development of government's role in Africa's financial systems and suggests a framework and taxonomy for defining options for government intervention in the financial sector. This debate in Africa is largely parallel to discussions in other regions of the world. It started with a prominent role for governments after independence in the 1960s and 1970s, followed by a withdrawal of government in many countries in the 1980s and 1990s. By now, a consensus is emerging that sees a prominent role for governments, beyond providing macroeconomic stability and the institutional framework, in taking a more active, but market-friendly approach. We will discuss each of these different approaches in turn and, at the end, point to unsolved questions and debates.[3] We will also discuss to which extent the lessons from the East Asian miracle can be applied to Sub-Saharan Africa.

3.1. From market- to government-failures– challenges and pitfalls of an activist agenda

Supported by International Financial Institutions, in the 1960s and 1970s governments had traditionally a strong role in African financial systems, ranging from regulatory restrictions (interest rate ceilings and floors etc.) over directed credit programs to government ownership of banks and Development Finance Institutions (DFI). This activist approach aimed at replacing markets that did not exist at the time of independence, with governments directly involved in financial service provision. The goal was to support sectors and industries that were traditionally shut out of the market-

[3] Honohan and Beck (2007) provide a more in depth discussion of the activist and modernist approaches to financial sector policies, while Beck and de la Torre (2007) provide a taxonomy of the different financial sector policies in relation to the market place.

based financial system, such as agriculture, small-scale industries and industries depending on long-term finance.

The outcome of these market-replacing efforts has been disappointing, both on the financial and the real-sector side. This can be explained by flaws in the two main assumptions of the market-replacing approach. First, governments know better than markets, and, second, governments act in the best interest of society. Both assumptions have been proven wrong across large parts of the developed and developing world. Bureaucrats have turned out to have limited knowledge and expertise to run financial institutions and systems and they do not maximize society's welfare but rather their own and are subject to political and regulatory capture, i.e. influence from the political sphere and the regulated entities, as hypothesized by the private-interest view (Barth, Caprio and Levine, 2006).

After 20 years of a market-replacing activist approach, Africa's financial systems were still shallow in the early 1980s, its government-owned banks and DFIs ridden with non-performing assets and access to financial resources limited to the few and connected. Many countries suffered banking crises in the 1980s and 1990s. At the peak of regional financial distress (1995), 27 African countries suffered from banking crises, 20 of them systemic (Laeven and Valencia, 2008). While the usual ingredients of banking crises – macroeconomic boom and bust cycles and bad private banking – are also present in banking crises in Sub-Saharan Africa, government failures are the leading cause. In many countries, such as Mozambique Tanzania, Uganda, and Zambia, large government-owned banks had to be rescued and sold. All in all, the financial system did not fulfill its growth-enhancing role.

Many factors have contributed to the failure of the market-replacing approach, but governance challenges feature prominently. Political capture of government bankers and regulators resulted in deviations from sustainable and efficient banking. Corruption in courts and government alike undermined investors' confidence. All of this resulted not only in large fiscal losses for governments and ultimately society, but also foregone growth due to inefficiencies and misallocation of scarce resources and skills.

3.2. The modernist approach – big expectations only partly fulfilled

Again following the advice of International Financial Institutions, many countries in Sub-Saharan Africa started liberalizing and privatizing their financial systems in the 1980s and 1990s. While the Washington Consensus cannot be exactly seen as laissez-faire approach, it puts a heavy emphasis on markets over government. There is a focus on monetary stability, market-based price finding and market-based provision of financial services. Disappointment with state owned commercial banks led to an emphasis on their privatization. At the same time, disenchantment with the DFIs resulted in drying up of donor funding for these institutions.

Sub-Saharan Africa has made significant progress in monetary stability, as Figure 8 shows. With the exception of a few outliers, most notably Zimbabwe, most African countries have achieved inflation below 20% over the past few years. Sub-Saharan Africa has also made substantial progress in private ownership in banks, as Figure 9 illustrates. Most countries' banking systems are today dominated by privately-owned financial institutions, be they domestic or foreign.

These reforms and their achievements in monetary stability and private ownership, however, have only partly fulfilled their expectations. African financial systems are significantly more stable than before. The write-down of bad loans has led to a shrinking of the financial systems in some countries, but overall financial intermediation has improved in many countries (Figure 10). But in spite of these progresses, Africa's financial systems are still characterized by their shallowness, by their high costs, exemplified in high interest rate spreads, and by limited access to finance. While an increase in interest spreads was to be expected after liberalization, their continued high level in most countries of the region has turned into a serious concern for policy makers (Figure 6).

The emphasis on market-based financial intermediation has also resulted in a trend towards establishing stock exchanges, often in connection with privatization programs. 15 out of 46 countries in Sub-Saharan Africa now have stock exchanges. While four of these exchanges have been set up in the times of the British Empire, most were only established in the past two decades or so. With the exception of the Johannesburg exchange, all exchanges are characterized by small market capitalization, even in relation to GDP, and an even lower turnover, i.e. liquidity. The actual float of the listed companies is low. The low transaction volume in both primary and secondary markets is self-enforcing, as it deters new issuers. Only 13 countries have seen corporate bond issues, and in all these cases the issues have been highly concentrated in the telecommunication and banking sectors (IMF, 2008). While there have been some signs of improvements, such as large IPOs on the Ghanaian, Kenyan and Nigerian stock exchanges, it is unlikely that they will turn capital markets sustainable. Attempts at regional markets have been less successful than expected, as the above discussed example of Abidjan shows or the continuous political struggles on creating a similar regional exchange for the Central African monetary union.

The limited success of the modernist approach can be mostly explained by its over-zealous application. Approaches from developed or advanced emerging markets are often transplanted into the African region without taking properly into account its context, such as size, informality and governance challenges.

Take the example of privatization. International experience from developed and developing countries alike has shown that private ownership of financial institutions results in sounder, more efficient and even more inclusive banking than government ownership (World Bank, 2001). Poorly designed and executed privatization processes, however, can lead to fragility and banking crises as numerous examples have shown over the past 30 years, such as in Uganda and Mozambique. Political interference into the process can result in fragile and unsustainable ownership and governance structures of the new private banks.

Another area where the modernist approach overreached is in the area of regulation, both of banks and markets. Applying regulatory and supervisory approaches designed for sophisticated financial institutions and well-trained supervisory capacity to the African context with limited supervisory resources and capacities but also much more basic banking markets has been inappropriate if not hurting. Take the example of Basel II, which relies on risk models and differentiated capital requirements beyond the capacity of many regulatory entities in Africa. AML/CFT regulations that impose documentation requirements on depositors that most households in Africa cannot comply with effectively shut large proportions of the population out of the formal banking market. Similarly, applying financial market rules designed to protect mass investors ignores the African reality that in most countries it has been mostly sophisticated investors who have access to financial, especially corporate bond, markets in the first place.

While deficient governance standards undermined the activist approach, they do not help the modernist approach either. In many instances, reforms were partial, but carefully designed not to undermine the elites' privileges. Take the example of Nigeria in the 1980s. In the context of the Structural Adjustment Program (SAP) in 1986, interest rates and entry into the banking system were liberalized, and credit allocation quotas loosened. At the same time, while ending direct rationing of foreign exchange for the real sector, the government maintained a multiple exchange rate regime, thus opening a new area of arbitrage and rent seeking for financial institutions and their politically connected owners that had privileged access to foreign exchange auctions (Lewis and Stein, 2002). In the following years, the number of banks tripled from 40 to nearly 120, employment in the financial sector doubled and the contribution of the financial system to GDP almost tripled (Lewis and Stein, 2002). While this seemed to vindicate the modernist agenda, financial intermediation actually dropped. Deposits in financial institutions and credit to the private sector, both relative to GDP, decreased over the period 1986 to 1992. The increasing number of banks and human capital in the financial sector was channeled into arbitrage and rent-seeking activity rather than financial intermediation. This experience does not imply that partial and gradual reforms are not a feasible approach, but rather that the effect of reforms will have to be seen in the overall context and in relation to other market- and government failures.

3.3. Enabling markets – broadening the policy space

The disappointment with the outcomes of the modernist approach adopted through the past two decades of African financial sector reforms has fostered yet another swing back towards more government involvement; this time around, however, more towards a market-friendly role that creates and enables markets instead of trying to replace them.

Over the past 10 years, there has been increasing emphasis beyond macro-stability toward strengthening the underlying institutions for an efficient and stable financial system, including the contractual and informational frameworks and incentive-compatible regulation and supervision. This policy approach can be referred to as market-developing approach – create markets rather than replace them. Unlike both the activist and modernist agendas of previous years, however, the agenda of this new market-developing approach is daunting, as it involves long-term institution building. It ranges from the contractual framework over informational requirements to bank regulation and supervision. It goes beyond transplanting laws and rules from the developed world to building up capacity and norms. The role of governments in this context is a difficult one – going beyond setting the rules, but without strangling private initiative.

The institution building agenda in the contractual system is a large one and reflects the deficiencies in the respective laws and their enforcing institutions. It ranges from modernizing bankruptcy legislation over improving the court system or building alternative dispute resolution mechanisms to establishing or improving asset and collateral registries. Few countries currently have credit registries or credit reference bureaus, an indispensable part of an effective and competitive system of financial intermediation. Many Central Banks and regulatory authorities still lack the necessary political and operational independence and have limited supervisory skills and tools at their disposal.

Institutional reform, however, cannot be a "one-size-fits-all" approach. Recent cross-country research has helped identify some priorities among the institution building agenda for low-income countries. Specifically, improvements in the contractual framework, such as creditor rights, have a relatively larger effect on financial intermediation in high-income countries, while improving credit registries has a relatively larger impact on financial deepening in low-income countries (Djankov, McLiesh and Shleifer, 2007). A second piece of evidence on reform prioritization comes from the transition economies of Central and Eastern Europe. Focusing on enforcement mechanisms for simple contractual arrangements such as collateral recovery can result in more benefits than reforming more complicated multi-stakeholder conflicts such as bankruptcy (Haselmann and Wachtel, 2007).

In addition, legal system reforms have to be context-specific, specifically with respect to the legal tradition. In spite of its shortcomings and deficiencies, court systems in the former British colonies still have a reasonable reputation. They can rely on a large body of case law and precedents, from London and other parts of the former British Empire. What courts in many Common Law countries Africa's are missing are capacity and financial-sector specific skills. The introduction of Commercial Courts might be helpful in this context. The situation in most Civil Code countries in Africa is different, where courts have deficiencies along many dimensions and suffer from very low reputation. Here the establishment of Alternative Dispute Resolution systems might be more helpful.

Beyond context-specific institution building, there are other "low-cost" short-cuts that have been identified through experience. Creating the necessary legal and regulatory frameworks for leasing and factoring is among them, as both financing techniques are especially conducive for SME lending.

The regulatory and supervisory framework can also be an important lever for financial deepening and broadening, beyond its important stability role. Specifically, the regulatory framework can critically influence the degree of competition and innovation in a financial system. Allowing entry from new reputable market players, be they domestic or foreign, can be important to maintain contestability and competition, especially in small financial markets. Adjusting loan classification and capital requirements so as not to bias against agricultural or SME loans can be important, as the following two examples illustrate. Adapting the loan classification system to allow bullet loans rather than forcing quarterly repayments can help agricultural lending synchronize with farming cycles. Given the lower tail risk of SME loans (in spite of their higher overall riskiness) implies lower capital charges for SME lending (Adasme, Majnoni and Uribe, 2006) Another important area of competition where government action might be necessary is to ensure access to payment system and other network services on an equal basis for all financial institutions – incumbent and new – that qualify under proper and fit criteria. Finally, the current push for and implementation of tougher AML/CFT regulations has critical repercussions not just for financial integrity and stability, but potentially negative consequences for the deepening and broadening of the financial system.

Sometimes, the role of government in fostering access might have to go beyond competition policies and take the form of "affirmative regulatory policy". Examples include the moral suasion exercised by authorities to make South African banks introduce the Mzansi (basic transaction) account. Inducing banks to share or ensure interoperability of payments infrastructures (including ATM networks) can help avoid undesirable competition on access to infrastructure while enhancing desirable competition on price and quality of service, thereby facilitating the achievement of cost-reducing scale economies and lowering entry barriers to new financial service providers.

Moral suasion can be an important policy lever, but has its limitations. Larger countries with larger potential markets might have an easier time of elbowing their banks into taking certain actions (such as establishing basic transaction accounts or opening up network services) than smaller markets. Further, there is a fine line between moral suasion and political interference, as the recent example of Uganda has shown. Frustrated by the insufficiency of earlier attempts to increase access to financial services, in early 2006 the Ugandan Government announced its intention that each district should be serviced by at least one financial institution. In those districts where no financial service provider was in operation the Government mandated the establishment of SACCOs to be supported with payments services etc. supplied by the poorly managed government-owned Postal Savings Bank.

Market-enabling policies – including at times through using DFIs - can also try addressing hindrances and market failures such as coordination failures, first mover disincentives, and obstacles to risk distribution and sharing. While not easy to define in general terms, given their variety, these government interventions tend to share a common feature in creating incentives for private lenders and investors to step in, without unduly shifting risks and costs to the government. Latin America offers several examples for such “market-friendly roles for the visible hand”, as described by De la Torre and Schmukler (2006). Specifically, they present case studies of such intriguing examples as: (i) the creation of an internet-based market for the discounting of post-delivery receivables by SMEs in Mexico; (ii) a Chilean program to promote lending to SMEs via the auctioning of partial government guarantees; and (iii) a variety of structured finance packages orchestrated by a Mexican development fund to finance agricultural production (e.g., shrimp, corn). Examples in Africa include the partial credit guarantee, with 50-50 risk sharing, established by the Bank of Tanzania, and the World Bank supported Africa Trade Insurance Facility that provides cover for political risk. Another important area where DFIs can help is in infrastructure financing, where private market players are often reluctant to enter given political and economic uncertainty and the current global crisis has reduced the necessary risk appetite for foreign investors even further. The role of the Development Bank of South Africa in catalyzing private participation in projects at the municipal level is an interesting example to study.

For all the questions these market promoting interventions raise—and their systematic study is at a too early stage to provide definitive answers—there is growing evidence that clearly argue for new roles for existing DFIs beyond the traditional provision of directed lending at the retail level, but might require adjustments in their business models and governance structures. One of the major challenges with any government-based solution is a governance structure that avoids political capture of the program and expropriation of the benefits by the few connected. This is where donors can play an important role as well as regional institutions, both of which are more removed from direct political pressure on the national level. Learning from positive examples within the region is also important in this context. The governance structure of Development Bank of South Africa (DBSA) has been studied extensively in this context (Scott, 2007). This is also where the role of government interacts with the benefits of globalization.

3.4. The role of subsidies

An important but also controversial aspect of government intervention are subsidies. Subsidized lending interest rates were an important component of the earlier activist financial sector agenda. Even now, subsidized interest rates are still seen as critical in supporting certain risky sectors or borrowers with need for small loan amounts that will not be able to pay market-based interest rates. However, by now the perverse incentives stemming from subsidized interest rates are well known – both in theory and in reality (Adams, Graham and von Pischke, 1984). First, artificially low interest rates increase demand beyond available funds, which results in a non-market based credit allocation process, where more influential and wealthy borrowers typically end up with the credit rather than unbanked borrowers who need it most. Second, subsidized interest rates often send the message that the loan or a large component thereof can be treated as grant rather than loan, which reduces repayment performance, with negative repercussions not just for the subsidy providing institutions but also other institutions, be they incumbent or new ones considering entry.

This does not imply that subsidies cannot have a useful and important function. For example, subsidizing the start-up of new financial institutions that go down-market or provide services to previously unbanked segments can be useful. Subsidies should focus on overcoming the two main deficiencies that make service provision so costly in a non-distorting way. First, one can subsidize the fixed cost component of transaction costs, e.g. subsidize costs of setting up a branch, a cooperative or even a local financial institution. Second, lending risk could be reduced through better possibilities of risk diversification, such as properly designed credit guarantee schemes or complementary products such as insurance, thus enticing private financial institutions to increase outreach. Such subsidies can also help reduce the high interest rates without distorting incentives though interest rate caps or subsidized interest rates.

In addition, the focus of government has been mostly on fostering and subsidizing credit services. As discussed above, however, other financial services, such as deposit, payment and insurance services are more important, particularly for low-income households with no prior access to financial services. Especially in the area of deposit and payment services, subsidies can be less distorting as they do not necessarily provoke moral hazard risk. Specifically, subsidizing the set-up of new outlets or new technologies can be worthwhile. The most prominent recent example is certainly M-Pesa in Kenya, where seed money from DfID through a so-called challenge fund (inviting open competition to stimulate and focus the attention of innovative solutions) helped jumpstart this cell-phone payment service in 2006, which by now has reached several millions of Kenyans, many of which were previously unbanked.[4]

This brings us to a more general point on subsidies and technology. It might be more worthwhile to foster innovation and adaption of new delivery channels and financial products than subsidizing established institutions and products. Fostering innovation is best done through ensuring a competitive environment and a conducive regulatory framework. Subsidies might be best employed for new approaches, as the example of Kenya shows. Having a competitive financial system that is also open to new international products and technologies can be critical.

3.5. Lessons from East Asia for Africa

The East Asian miracle has often been heralded as proof that non-orthodox government interventions can have a positive growth impact. Specifically, on top of sound macroeconomic policies, many East Asian countries adopted policies that go counter to the modernist approach, including targeted and subsidized credit, interest rate floors and ceilings and government-owned banks (World Bank, 1993). Most East Asian economies relied on development finance institutions as a catalyst for funding investment projects. What, if any, lessons do the East Asian success stories hold for Sub-Saharan Africa?

There are several important lessons from East Asia for Sub-Saharan Africa (World Bank, 1993). First, macroeconomic stability was key to the success of the East Asian economies. Second, policies to encourage savings in East Asia have been a critical

[4] Subsequently DFID announced another challenge fund for Government to Person (G2P) payments so as to facilitate the transfer of resources to Orphans and Vulnerable Children under a Government sponsored program. Recently DFID has also taken the lead on programs to strengthen financial literacy.

part of their success story, accompanied by efficient financial intermediation. Beyond these two important – and mostly uncontroversial dimensions -, however, the East Asian governments heavily intervened in markets. As discussed by World Bank (1993), the success of East Asian government interventions relied on complementing market-based competitiveness with government-induced contests that combine cooperation with competition. Rewarding industries and firms that use subsidies successfully – often judged by their ability to export -, while withdrawing subsidies from failing enterprises has been a critical part of the East Asian approach. So while non-orthodox instruments were used, they were continued only while there was evidence of success, with exports being a good indicator and easy to monitor. And, more importantly, these measures were removed when they did not or no longer worked.

Many of the non-orthodox policies successfully implemented in East Asia have not worked in Sub-Saharan Africa. Financial repression and industrial policies have had little if no positive impact on financial and economic development in Sub-Saharan. To the contrary, financial repression has depressed savings and resulted in mis-allocation of credit. As discussed above, directed credit and government-owned banking have resulted not only in large losses, but have distorted credit markets and resource allocation, with negative repercussions for economic growth and equity.

Why have government interventions worked in East Asia, but not in Sub-Saharan Africa? Most activist government interventions have not taken place with the necessary macroeconomic stability as fundament, but have rather undermined it through large contingent and actual fiscal losses. Decisions on starting and continuing specific interventions were not driven by performance criteria, but mostly political considerations.

A more structural comparison of East Asia and Africa points to several underlying deeper factors. First, the lack of scale and limited geographic connections reduces the possibilities to apply such a contest-cum cooperation approach in most Sub-Saharan African countries. Second, limited implementation and monitoring capacity has undermined the success of activist government interventions. Most importantly, however, ethnic fractionalization in most countries of the region can explain why the necessary political stability and institutions do not exist that are so critical for the success of government interventions (Easterly and Levine, 1997). Ethnic fractionalization can result in uncoordinated rent-seeking activities, exacerbate common pool problems and lead to suboptimal public good provision. Government interventions are not informed and driven by economic policy objectives but by private interest and contest-cum-cooperation is not feasible in such an environment. The reliance of many African economies on natural resources further increases incentives for rent-seeking activities and undermines political stability.

East Asia, however, also offers negative lessons for Sub-Saharan Africa, especially in the wake of the East Asian crisis. Accompanying financial deepening with appropriate regulation and supervision, as well as disclosure transparency standards is critical to ensure sustainable credit growth and growth-conducive financial development and avoid bubbles ending in financial fragility.

In summary, the East Asian experience underlines the potential for a role of government beyond macroeconomic management and institution building, but also shows the necessary conditions needed to make it work. It shows the potential of activist policies if combined with the necessary safeguards and implementation and monitoring capacity, most importantly the necessary governance structures. While many of the activist policies have not worked in the past in the African context, context-specific and cautious government interventions that try to crowd in and rather than replace the market, might be more promising. Critically, recent achievements in macroeconomic stability and bank restructuring might serve as basis for a more active government, with the caveat that any government intervention is not to undermine these same achievements.

4. The challenge of globalization

Integration into international financial markets has been a second important and controversial aspect of financial sector policy. While most African countries have opened their financial systems up to foreign bank entry, capital account restrictions are still in place in many countries, although often more de-jure than de-facto. In this section, we will discuss two dimensions of globalization, capital account liberalization and foreign bank entry. Finally, we will discuss the unfulfilled potential of regional arrangements as important mechanism to overcome diseconomies of scale in Africa and to address governance deficiencies on the national level.

4.1. Capital account liberalization

While capital account liberalization has long been seen as important component of the modernist Washington-consensus agenda, the crisis experience in East Asia and other emerging markets in the 1990s has led to a more cautious approach. Cross-country comparisons do not yield consistent results; on the one hand, most cross-country comparisons, using broad indicators of capital account restrictions show an insignificant relationship between capital account liberalization (Levine and Zervos, 1998; Rodrik, 1998).[5] On the other hand, analyzing the effect of a specific policy reform – opening equity markets to foreign investors - Bekaert, Harvey and Lundblad (2005) and Henry (2000, 2003) find a positive effect on investment and growth and negative effect on the cost of capital for the years following opening. Researchers have found positive effects of equity market liberalization that are especially strong for firms and industries that rely most on external finance (Gupta and Yuan, 2005; Forbes, 2007; Harrison et al., 2004).

However, there is an increasing consensus that the largest effect of capital account liberalization does not seem to come from increased capital flows, but rather from higher productivity growth and "collateral benefits" (Kose et al., 2007), such as institutional and financial deepening and macroeconomic stability. Specifically, opening the capital account can serve as commitment device to sound fiscal and monetary policies, can increase corporate and public governance structures, can enhance competition and deepen financial markets.

However, there might be a threshold value in economic, institutional and financial development below which countries do not benefit from capital account liberalization (Kose et al., 2007). Capital inflows critically depend on financial markets and institutions. Foreign investors need capital markets to invest in equity or debt, unless they create subsidiaries or create joint-ventures. Even portfolio investors need institutions or markets to invest in. The depth and liquidity of local markets as well as the foreign exchange market will therefore be decisive in establishing their interest (Hermes and Lesink, 2003; Alfaro et al., 2004). Critically, governance will be important in order

[5] As Henry (2007) points out, this is consistent with neoclassical growth theory that predicts an increase in GDP per capita, but not a permanent growth effect from capital account liberalization.

for countries to reap the benefits of international capital flows, as the example of resource-based economies show where the corresponding capital inflows are not always properly accounted for and used in public interest. Not surprisingly, cross-country comparisons show a positive effect of capital account liberalization only for countries with well-developed institutional frameworks and financial markets (Klein and Olivei, 2009).

Even if the benefits of capital account liberalization are not clear-cut, the costs of capital controls and multi-tier exchange rate systems have been clearly documented. Such controls often result in rents exploited by connected entrepreneurs and thus corruption (see Johnson and Mitton, 2002 for Malaysia; Lewis and Stein, 2002 for Nigeria). Even where imposed with good intentions, they fall easily prey to regulatory and political rent-seeking. This effect is especially strong in countries that are more prone to rent-seeking and common-pool problems, such as countries with ethnically more heterogeneous populations (Chanda, 2005).

An important question, however, is how effective capital account restrictions are in the first place. Unless countries want to forego benefits from trade liberalization – much less in doubt than benefits of open capital accounts – any restrictions on capital movements will become less and less effective as capital can be moved through the financial transactions accompanying international trade transactions. Overzealous attempts to prevent any capital outflow by, e.g., prohibiting the issue of credit cards, even for domestic use, can have negative side effects on financial sector deepening and broadening and prevent countries from benefitting from modern technology.

The evidence on the effect of actual capital flows on economic development is similarly ambiguous as that of capital account liberalization. In international comparison, the fastest growing economies are often those with least foreign capital inflows and rather relying on domestic savings, as especially East Asia has shown. Rapid economic take-off has often been associated with current-account surpluses and thus capital outflows rather than inflows (Prasad, Rajan and Subramanian, 2007). This in turn matches with the observation that many if not most African economies suffer from a lack of investment opportunities and intermediation inefficiencies rather than from the lack of resources. Even worse, too rapid capital inflows (be it through aid or private capital flows) might lead to real exchange rate overvaluation and loss of competitiveness - the Dutch disease phenomenon -, with long-term negative repercussions for private sector and overall economic development.

Cross-country comparisons have shown that the composition of capital flows is critical for its growth effect. While FDI and portfolio capital inflows have mostly a positive impact on (productivity) growth, debt inflows have a negative impact (Kose, Prasad and Terrones, 2009). In addition, equity inflows, especially FDI flows, tend to be more stable, as they are less procyclical involving risk-sharing, while debt flows are extremely procyclical and prone to sudden stops. Payments on equity claims are typically pro-cyclical, while payments on debt are counter-cyclical. Heavier reliance on debt rather than equity inflows thus makes economies more vulnerable to sudden stops, capital flow reversals and crises. As in other regions of the world, experience – such as the cautious opening in Ghana – has shown that it is also more important to focus on long-term liberalization before short-term opening.

While the impact of capital account liberalization and capital flows is thus subject to important threshold effects in institutional and financial development, institutional and financial deepening also constitute important “collateral benefits” of capital account liberalization (Kose et al., 2007). This presents low-income countries in Sub-Saharan Africa with deficient governance structure and weak financial markets with difficult choices; on the one hand, benefits of capital account liberalization can only be reaped in the presence of reasonably well developed financial markets and institutions, on the other hand, opening up the capital account can lead exactly to the much needed financial and institutional deepening. A pragmatic approach, such as suggested by Prasad and Rajan (2008), seems thus most reasonable; allowing domestic agents to invest abroad through a closed-end investment fund would constitute a gradual approach that limits risks and vulnerabilities.

While Sub-Saharan Africa is somewhat protected against a direct negative impact of the current financial crisis in the U.S. and Europe given its limited integration into global financial markets, but also due to its lack of sophistication, Africa will not be able to disconnect itself from the negative repercussions of the crisis for the world economy. More importantly, one has to look beyond the current crisis and consider the long-term costs and benefits of integration into global financial markets. Opening up to portfolio flows entails significant risk that can only be managed through sound macroeconomic policy. While the current global environment might not be an appropriate one for opening the capital account, taking a more liberal approach towards intra-regional capital flows might be an important alternative and first step, as we will discuss below.

The increasing inflows from China and other non-OECD countries, especially in the context of infrastructure financing (Foster et al., 2008), offers opportunities for the region. These flows bring long-needed resources to improve the deficient physical infrastructure. On the other hand, these flows seem to be targeted mostly towards resource-rich economies, such as Angola, with many transactions following the example of the Angola-mode where loan repayments are partly made in-kind, in the form of natural resources.[6] These South-South inflows hold great potential for the region starved for long-term resources. However, they cannot replace policies to foster the development of long-term financial markets, such as through pension funds. Evidence from other regions suggest that funded pension schemes as they already exist in many African countries can contribute to both savings and improved resource allocation.

Summarizing, capital account liberalization has many benefits but has to be managed carefully on the macro-economic level and accompanied with appropriate regulatory policies. The benefits of increased capital inflows will only be reaped in the presence of well-developed local financial institutions and markets, but can in turn accelerate financial and institutional deepening. As in the case of government interventions, a context-specific and pragmatic approach is called for.

4.2. Foreign bank entry

Foreign bank entry has been another controversial aspect of financial globalization, perhaps even more so than capital account liberalization. Africa's banking systems were dominated by foreign-owned banks before independence, while subsequent

[6] The Angola mode is a deal structure used by the China Ex-Im-Bank whereby repayment of the loan is made in natural resources. See Foster et al. (2008) for details.

nationalization and "Africanization" reduced the share of foreign ownership significantly. In the context of financial liberalization in the 1990s, many foreign banks returned, while at the same new foreign banks, from South Africa and Western Africa, expanded throughout the region. By 2005, almost half of Africa's financial systems were dominated by foreign-owned financial institutions (Figure 9).

Theory does not provide clear predictions on the effect of foreign bank entry on financial depth and outreach. On the one hand, foreign bank entry can bring in new resources and expertise, with positive repercussions for financial and economic development. On the other hand, the advantage of foreign banks in processing hard information about borrowers as opposed to relying on soft information can have negative repercussions for riskier and more opaque borrowers if foreign banks crowd out domestic banks.[7] While empirical work has found that foreign bank entry and participation has, more often than not, had a positive effect on efficiency and stability of host countries' financial systems, the findings on foreign bank entry's effects on depth and outreach are ambiguous (see Cull and Martinez Peria, 2007 for an overview). Bank-level evidence often points to the reluctance of foreign banks to cater to smaller enterprises, while firm-level evidence does not report any adverse effects of foreign bank entry for these firms.[8]

Foreign bank entry seems to have several advantages that are specific to Africa: international banks can help foster governance; they can bring in much-needed technology and experience from other regional economies (in case of South African or

[7] See, for example, Gormley (2007), Sengupta (2007) and Detragiache et al. (2008).

[8] Using cross-country regressions, Detragiache et al. (2008) show a negative relationship between foreign bank participation and financial depth. Similarly, Mian (2006) and Gormley (2009) show for India and Pakistan, respectively, that foreign-owned banks are less likely to lend to riskier and more opaque borrowers and might crowd out domestic banks, with negative repercussion for overall access to credit. Clarke et al. (2006), on the other hand, find that firms, including small ones, are less constrained by access to and cost of finance in countries with higher levels of foreign bank participation.

West African banks) and they can help exploit scale economies in the small host countries. On the other hand, it is especially in Africa with its many small, risky and opaque enterprises, that the dark side of foreign bank entry can become obvious, even more so in countries where foreign banks have captured almost 100% of the banking market. In addition, there are many factors that can prevent countries from reaping the potential benefits of foreign bank ownership. The presence of dominant government-owned banks can reduce competitive pressures and allow other banks – be they domestic or foreign-owned – to earn rents from the inefficiency of government-owned banks, as the example of Kenya shows. The absence of a sound contractual and informational framework reduces the feasibility of small business lending even further, as seen in Zambia where lending to the private sector as a percentage of GDP remains low at 12.8% despite two decades of financial liberalization. The small size of many financial markets in Sub-Saharan African markets might make foreign banks reluctant to incur the fixed costs of introducing new products and technologies. The small size of many markets also does not allow for the necessary competitive pressure. The result has been in many Sub-Saharan African countries concentration of both domestic and foreign banks' portfolios on government papers and international assets.

Nevertheless, the recent new generation of foreign banks in Africa has been more beneficial for outreach than foreign banks in the 1950s and 60s. The new wave of foreign bank entry after liberalization in the 1980s and 90s has seen the return of old colonial banks, but also some new important players, such as several South African banks, banks from regions other than Europe, and several regional banks, such as Bank of Africa and Ecobank. Several international banks have established a franchise in supporting the development of financial access, such as the Dutch Rabobank with (controlling minority) stakes in banks in Tanzania, Zambia and Mozambique, and more recently the Nigerian Access Bank focusing on improving access to finance by SMEs with subsidiaries in West Africa as well as in Kenya and Zambia. Many of these new entrants have put a much higher weight on sustainable outreach, introducing new products and technologies.

Two examples show the positive impact that foreign bank entry can have on access to financial services in Africa. On the one hand, in Zambia foreign banks have recently led a move towards providing greater access to financial services. Barclays Bank's recently engaged in quite an aggressive branch expansion program as well as investment in a local MFI. Rabobank's acquired a minority stake and the management contract for Zanaco (the traditional provider of commercial finance) with a mandate/commitment to expand provision of financial services in underserved rural Zambia. On the other hand, Uganda where after a first failed privatization of Uganda Commercial Bank (UCB) with subsequent renationalization, Standard Bank South Africa purchased this largest government-owned bank. Over the past years, Standard Bank did not only fulfill its commitment to not close any branches, it even opened new ones. It increased lending into agriculture (Clarke, Cull and Fuchs, 2006). However, this rather successful privatization also shows that foreign bank entry is not a panacea. Standard Bank still dominates the national banking market and many of the small up-country local markets. This lack of competition might have reduced the benefits arising from the shift from a government-dominated financial system to a privately-owned financial system.

In a nutshell, Africa has gained a lot from foreign bank entry in the past decade, including entry of Pan-African banks. Finance is more sound and efficient. Critically, foreign bank entry can provide for significantly more stable capital flows for countries than portfolio flows in the form of loans into financial markets and institutions, as a recent study for Peru showed (Schnabl, 2008). However, one should not downplay the risk of a foreign subsidiary dominating the financial system if the parent company is in trouble – a scenario that has become again more likely in the current global financial turmoil. It is in this context, that Pan-African banks might bring important stability advantages as they might be less exposed to problems in the developed world. However, foreign bank entry has not fulfilled so far its expectations in terms of financial deepening and broadening. It is again the new generation of Pan-African banks as well as the more development-oriented international banks that might bring more expertise and appetite to cater to broaden the banked population of enterprises and households.

While the landscape of foreign banking has thus changed and, on balance, foreign bank entry has helped with developing the financial sector in Africa, it is not the panacea to medium term financial sector development. There is room for the entry of new players, including non-banks and innovative financiers that will diversify the services and reach of the financial system.

4.3. Regional integration

The successful example of Europe in creating a large regional market with a joint currency, joint institutions and even coordinated policy making has been inspiring. There is an enormous potential for Africa in overcoming scale diseconomies by joining forces.

Not surprisingly, there have been numerous attempts at moving closer towards such cooperation. However, the results have been limited so far. Apart from three currency unions and two joint bank regulation and supervision authorities, most efforts have been on the level of coordination and exchange of experiences. One reason for the limited integration has been political, another over-ambition, as obvious from the idea of establishing a pan-African currency union. It is important to note that – as in the European Union – regional integration cannot and will not move at the same speed in all areas and segments of the financial sector. Focusing on smaller, economically and institutionally more homogeneous sub-regions, such as East Africa, might be more promising than trying to integrate larger regions with countries at different levels of financial development and different institutional and legal frameworks.

There are large economies of scale to be reaped by cooperation in technical areas, such as bank regulation or payment systems (World Bank, 2007b). By harmonizing bank regulatory frameworks, authorities can reduce regulatory costs for banks active across several countries of the respective region. Allowing banks to establish branches in other countries rather than having to establish subsidiaries reduces the costs of market entry – by reducing costs of, among others, multiple corporate structures - and can foster competition. It will thus help African economies to finally reap the benefits of scale economies that foreign banks were supposed to bring to their host countries. It is important to note, however, that introducing such a "regional passport for financial services" approach requires supervisory convergence if not integration, as the current crisis experience in Europe shows. Integrating payment systems can significantly reduce the costs of cross-border transactions and help increase intra-regional trade.

Reducing if not eliminating intra-regional capital account restrictions can help deepen and broaden financial systems within the region. It allows more efficient risk diversification for financial and non-financial corporations alike. It can help overcome the size problem for financing of large projects, such as in infrastructure. While reducing dependence on international capital markets to a certain degree, such intra-regional capital account liberalization seems less risky than complete capital account liberalization vis-à-vis international investors.

5. What does the 2008 Crisis Imply for Financial Sector Policy in Africa?

What are the implications of the current crisis for Africa's agenda in financial sector policy? The crisis has put into doubt many previously established positions on the role of government and on the risks and benefits of financial globalization. It certainly strengthens the growing view that the modernist approach of letting markets work for themselves is not sufficient, neither in developing nor in developed countries. Markets cannot be left to themselves but need a regulatory and supervisory framework that keeps aggressive risk taking in check. This is especially important in the presence of the moral hazard risk of expected bail-outs of financial markets and institutions, an expectation that has been proven correctly in the current crisis. While ex-ante government actions should aim at reducing this moral hazard (by limiting deposit insurance and government support programs, through bank failure resolution systems that punish risk decision makers first, as well as through adequate monetary policy signals), moral hazard risk cannot be eliminated completely, especially not in the situation of too-many and too-interconnected institutions. It is therefore indispensable to have in place regulatory and supervisory systems that can deal swiftly and effectively with large bank failures, protecting depositors adequately, protecting the franchise value of existing lending relationships and preventing the melt-down of financial markets. Even in banking markets with predominantly foreign bank ownership, authorities have to be prepared to take over subsidiaries of foreign banks if the parent bank fails, putting in place the necessary safeguards against the well-documented negative side effect of even temporary government ownership.

However, the current crisis also has government failure as one important root cause. In addition to the regulatory and supervisory learning curve that accompanied the rapid introduction of new products, there was a benign neglect on the side of regulators, especially in the U.S., combined with the creation of moral hazard risk by providing market participants with the expectation they would be bailed out in case of need both through monetary and financial policy, what is often referred to as the Greenspan-Bernanke put. The regulatory benign neglect was supported by the political aim of increasing house ownership. Most importantly, the current crisis especially in the U.S. reflects a movement beyond the access possibilities frontier (Beck and de la Torre, 2007) towards an unsustainable equilibrium with unjustified risk taking and poor lending practices. However, it is important to note that Sub-Saharan Africa seems to be far from such an unsustainable overshooting. In a region, where less than one in five households has access to formal financial services, such a scenario seems still remote.

Nevertheless, even the overreaching of outreach as in the U.S. with too easy access to credit has important lessons for Africa. It implies an incentive-compatible financial safety net that provides banks with incentives to take prudent and not excessive risks and prevents them from shifting the cost of their risk decisions to tax payers. But precautions are also important on the household level, protecting households from over-indebtedness; not so much by prohibitions and interest ceilings, but by enforcing disclosure requirements on financial institutions and financial literacy programs.

Does the widespread capital support by governments if not outright nationalization in the U.S. and Western Europe imply a comeback of government ownership of banks? At this point, it is hard to predict the development of crisis resolution in the North, but previous evidence suggests that government involvement in banking beyond a short emergency period will be detrimental not only to the recovery of the financial markets but also to their long-term development. And this might be perhaps the worst repercussion that Africa's financial systems can suffer from the crisis: a return to activist governments that try to replace markets – as imperfect as they are – with government provision of financial services, rather than creating and enabling markets and addressing its failures in a pragmatic fashion Governments do have an important role to play, but it should be in facilitating and encouraging private sector participants rather than in direct lending by government entities.

Another mistaken reaction would be to overemphasize stability concerns. Banking is fragile, especially in developing countries with weak contractual and information frameworks, but as discussed above, policy makers – especially in central banks and regulatory authorities - might have erred too much on the side of caution in recent years, rather than encouraging banks to take prudent lending risks. A regulatory backlash against further expansion of lending would be a mistaken lesson from the U.S. crisis.

6. Conclusions

Africa's financial systems have made substantial progress over the past decades but still face a daunting agenda. Most countries have achieved monetary stability and have created the conditions for private financial service provision. However, there is still a long agenda to be pursued and governments have an important role to play, both in medium- to long-term institution building, but also in more short-term policies. The extent to which government can actively intervene in the financial system, without crowding out private financial service provision, is very much a function of country characteristics, most importantly the size of the financial system. While it might be tempting to try to replicate the positive experiences with broad interventionist government policies in East Asia, the necessary pre-conditions, most prominently the necessary governance structures, are still to be built in Africa. Limited, cautious and context-specific interventions, on the other hand, might be more promising, especially if accompanied with the necessary implementation and monitoring capacity building and governance safeguards.

Globalization offers many potential benefits, but also costs; a cautious approach is called for. The size of the economy and financial system plays again a critical role. While larger economies can afford to forego the benefits of globalization as they can rely on domestic scale economies and possibilities of risk diversification, smaller economies stand to lose more from closing themselves against foreign capital. Few if any of the African economies, however, have the sufficient size to rely completely on their domestic economy. While the current crisis might seemingly vindicate attempts to close one's economy from the international financial markets, even closed economies will not be able to escape from the real sector repercussions of the crisis, but without a financial system in place that can provide the necessary tools on macro- and micro-level to cushion the impact of shocks. One size does not fit at all; possibilities for government intervention and a gradual opening-up approach vary positively with country size. Especially smaller countries stand to gain from regional cooperation, although it might be difficult without the presence of a larger "anchor" country.

The example of East Asia has underlined how important it is to strengthen domestic savings. While the current constraints are still mostly on the intermediation side, this might change. This will imply convincing savers and investors in Africa that the growth prospects are sufficiently good to save and invest in their economies. Also, it would indicate a shift from a resource exploitation paradigm towards a more sustainable and more equitable growth paradigm.

The current crisis presents additional challenges for Africa's policy makers, as the risk-appetite of international investors is falling to historic lows. It provides a strong impetus to develop local and regional financial markets; a task, which requires active governments that facilitate, encourage and crowd in private market participants. Government's agenda might well go beyond institution building toward more actively working with the private sector. However, here lies also the pitfall: turning back to government ownership of banks and closing the door to international financial markets can only hurt Africa.

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Figure 1: Finance and Growth

This graph shows a partial scatter plot between Private Credit to GDP and GDP per capita growth, averaged over the period 1980 to 2003, controlling for initial GDP per capita, government consumption, inflation, trade openness and education. Source: Beck (2006).

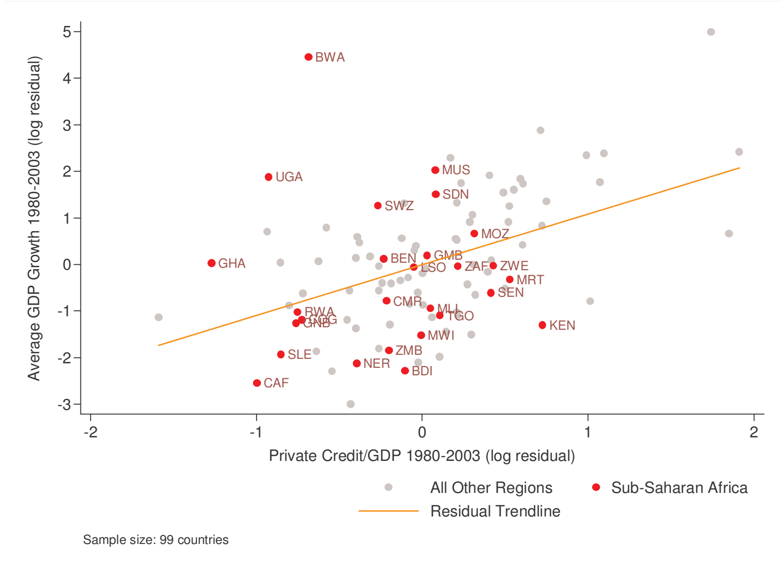

Figure 2: Finance and Poverty Alleviation

This graph shows a partial scatter plot between Private Credit to GDP and growth in headcount, the share of population living on less than a dollar a day, averaged over the period 1980 to 2003, controlling for initial headcount. Source: Beck, Demirguc-Kunt and Levine (2007).

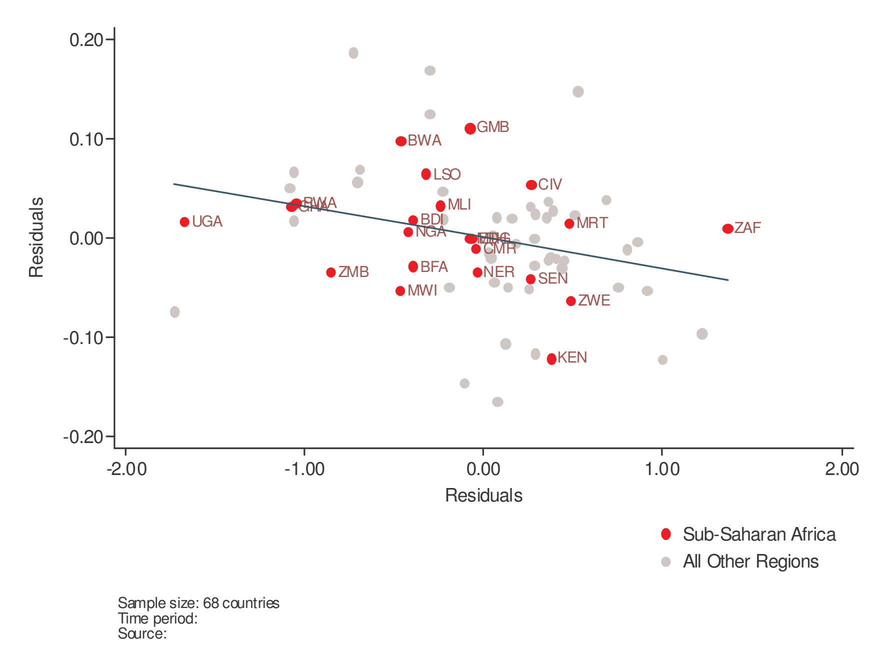

Figure 3: Liquid Liabilities in US dollars, across countries
This graph shows the log of Liquid Liabilities in millions of US dollars. Source: Beck and Demirguc-Kunt (2009).

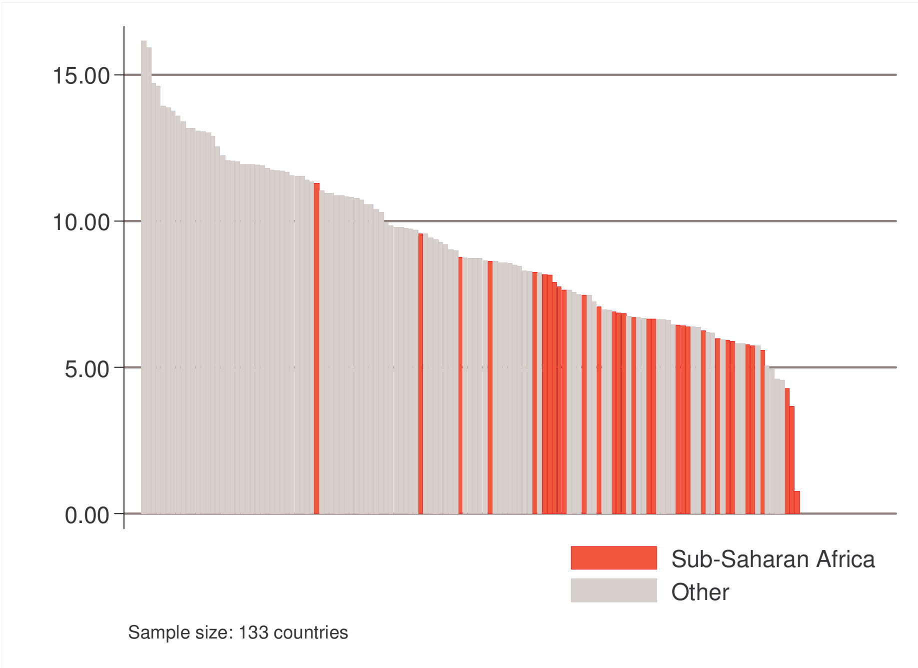

Figure 3: Liquid Liabilities to GDP, across countries
This graph shows the ratio of liquid liabilities to GDP, across countries. Source: Beck and Demirguc-Kunt (2009)

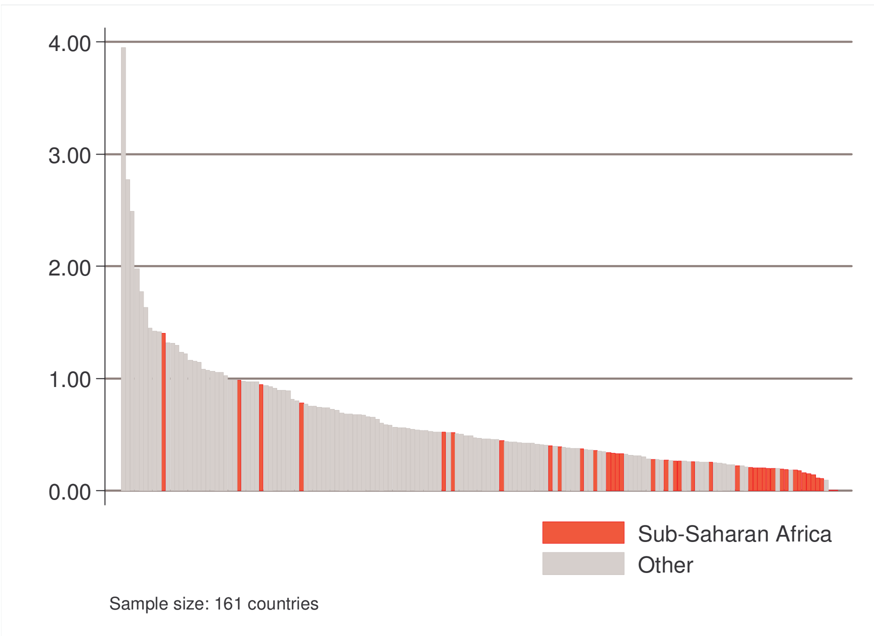

Figure 5: Access to Financial Services by Households across African countries
This graph shows the estimated proportion of households that has access to a financial account at a commercial bank, cooperative or microfinance institution. Source: World Bank (2007a).

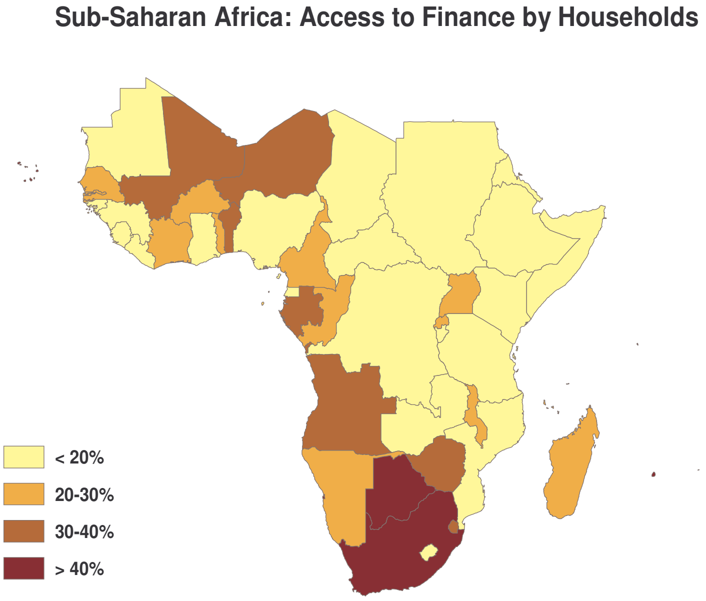

Figure 6: Net interest margins across regions
This graph shows 25th ,50th and 75th percentile as well as minimum and maximum of net interest margin (net interest revenue divided by total earning assets) across countries within each region. Source: Beck and Demirguc-Kunt (2009).

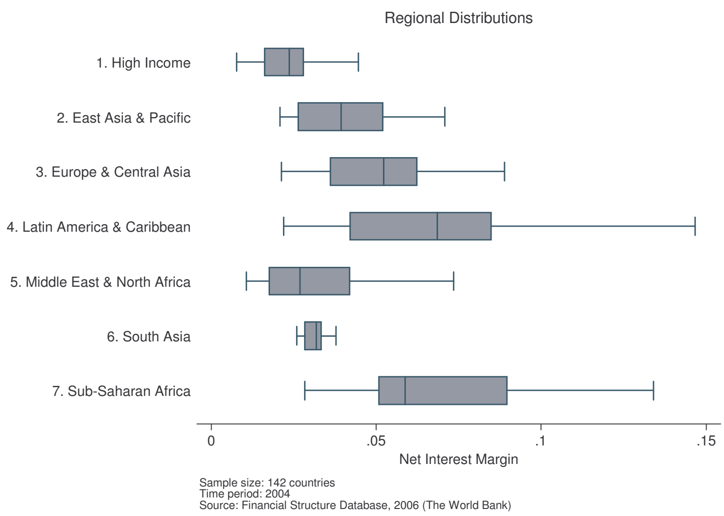

Figure 7: Financial development vs. GDP per capita
This graph shows the partial scatter plot between Private Credit to GDP and the log of GDP per capita, controlling for inflation.

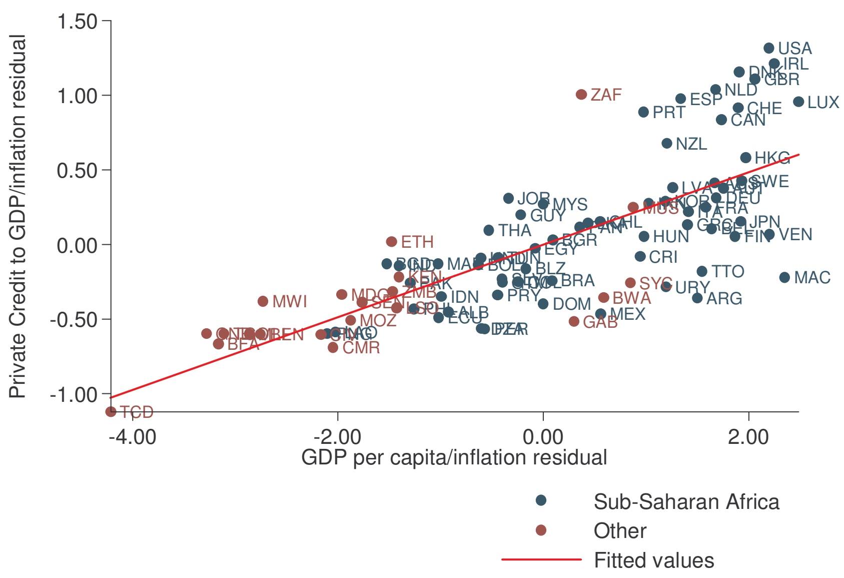

Figure 8: CPI inflation across countries
This graph shows 25th ,50th and 75th percentile as well as minimum and maximum of CPI inflation across countries within each region. Source: International Financial Statistics.

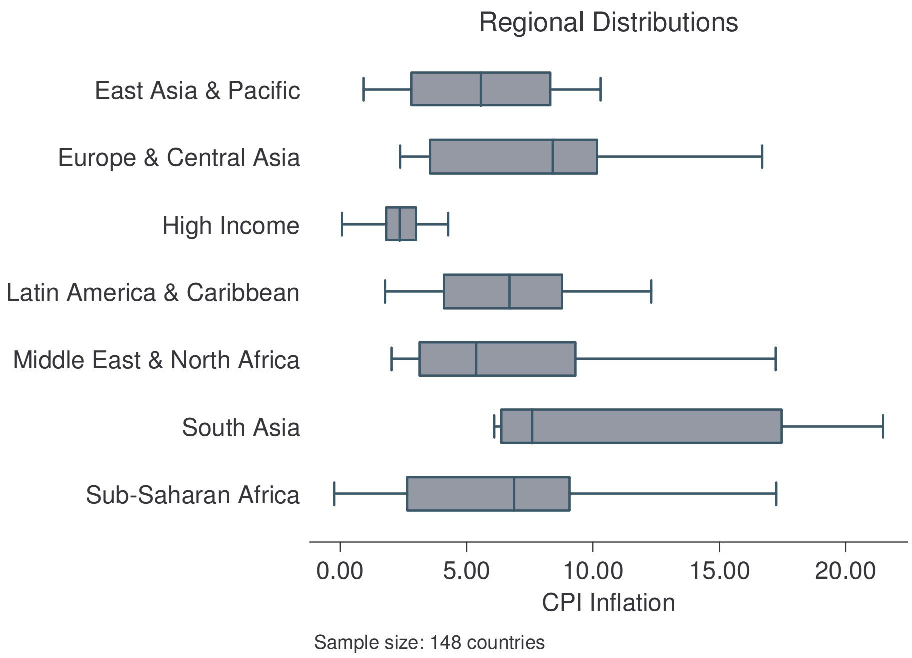

Figure 9: Bank ownership in Africa and other developing countries
This graph shows the predominant ownership patterns in Africa and other developing countries. Mainly government controlled, mainly foreign, and mainly local mean that more than 60 percent of total assets are held by banks majority owned by the government or majority owned by foreign or local shareholders. Foreign plus government means these two categories together hold more than 70 percent. Equally shared is a residual category. Source: Honohan and Beck (2007).

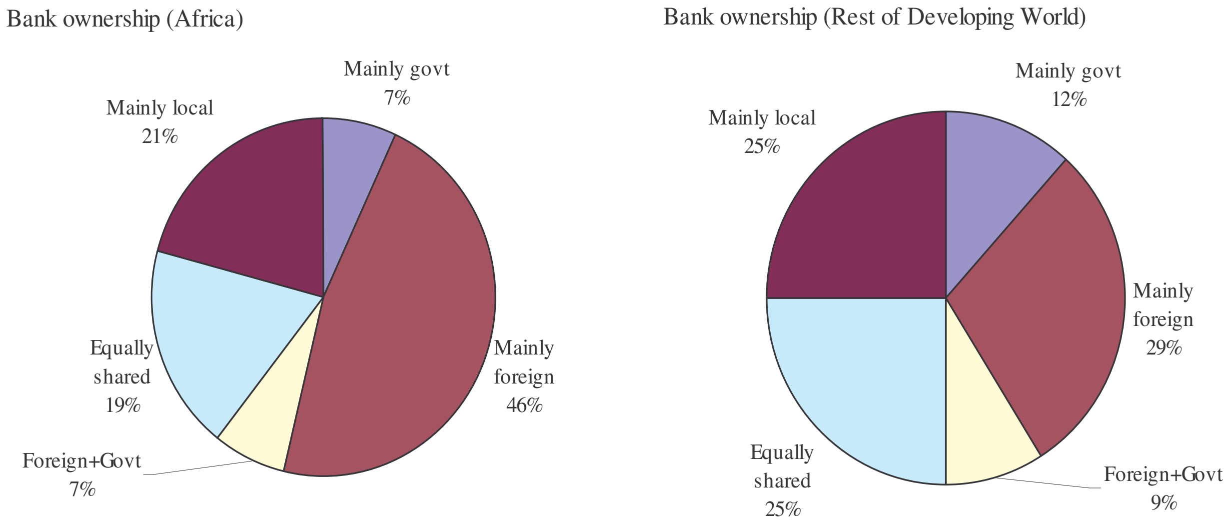

Figure 10: Financial deepening in Africa, 1995 to 2007
This graph shows the median of Liquid Liabilites to GDP, Bank Deposits to GDP and Private Credit to GDP. Source: Beck and Demirguc-Kunt (2009).