Financial Liberalization in Africa

Is there a sequencing issue of financial liberalization and, if so, are these conditions met in Ethiopia, and what are the lessons from Africa. I shall deal with these three questions.

Part 1

In theory the financial sector consists of two markets, one, which balances supply and demand of loanable fund, and another, demand and supply of money. The inter-play between these two, credit and money markets, respectively, bring about a market determined interest rate regime. It is the money market that governs the outcome on the interest rate. This implies an interaction between commercial banks and the central bank under the guidance of the latter.

For the central bank to determine interest rates, the public must have the option of holding financial assets other than cash whenever it wishes to, depending on the trade-off between liquidity requirements and interest income combined with capital gain or loss on the alternative asset. Furthermore, cash holding must have a determinate relationship with the flow of income and expenditure. In other words, both speculative and transaction demand for money should be operative. This allows the central bank to regulate the interest rate by selling and buying bonds and thereby altering the supply of money. Liberalization of the financial market in this context is appropriate and beneficial.

Part 2

In Ethiopia, there is only a primary market for T-bills and bonds. Thus the demand for money stands only on one leg, transaction demand. Even in such a situation, however, it is possible for the interaction between money market and credit market to effectively set interest rates and for the central bank to regulate money supply. This is to say that it is possible to have market determined interest rates. But, the relationship between cash holding by the public and real income should be stable. Given this stability, reserve requirements can be altered to regulate credit creation by commercial banks and, indirectly money supply.

Hence, given that open market operations are out of reach in Ethiopia, the and relevant question is whether the transaction demand for money in Ethiopia is stable, or, what amounts to the same thing, whether the real money balance effect brings demand into equilibrium with supply of money.

My contention is that in Ethiopia, as indeed in least-developed countries in general, cash holding by the public does not bear a stable relationship with aggregate income. This is mainly because wage income constitutes far less than half of the monetary national income. To start with, the share of the informal sector in the monetary GDP is relatively high, particularly in countries where mining is not important, which reduces the dominance of the formal sector. Moreover, the distribution of income between labour and capital is tilted towards the latter. While in the advanced countries the value added of the manufacturing sector in earlier decades was divided three-fourth to one-fourth between labour and capital respectively, the distribution in developing countries today is almost the reverse with, perhaps, one-third going to labour and two-thirds going to capital. Additionally, there are smallholder farmers whose income and expenditure flows are by no means synchronized. Hence conditions are not suitable for a stable transaction demand function.

In fact, transaction demand becomes more determinate along with the emergence of wage income to prominence in the distribution of the national income. This implies a transformation of the agrarian labour force into non-agricultural. As to speculative demand for money, it is clear, even from this brief discussion, that a stable transaction demand is a pre-requisite for it to be feasible.

The central bank can effectively operate on the credit market on its own by changing reserve requirements, particularly when interest-rate elasticity of investment is sufficiently high. Let me quote The Sunday Times (London) of 15/16 June 2003. Writing about the British economy it states:" a 1 percentage points hike in interest rates reduces economic growth of between 0.5 and 0.7 percentage points after a year"; according to a preliminary modeling by Oxford Economic Forecasting made for the paper. This is an excellent example of a highly elastic situation. Contrast this to what is found in least-developed countries, where lending rates by banks in Sub-Sahara Africa, for instance, are often extremely high. I take this as a prima-facie case for concluding that investment is interest- rate inelastic, at least over a wide band of lending rates. Raising reserve requirements, can then lead to a perverse result of inducing higher interest rates without reducing money supply.

A market based interest regime is possible in circumstances where the central bank lacks the instruments for open-market operations to vary the money supply, so long as demand for money and investment are both interest-elastic, or, possibly, at least the latter is found to obtain. However, these conditions are not met in Ethiopia, and, for that matter, in least-developed countries.

Financial liberalization is invariably inter-related with foreign exchange liberalization on the capital account. Countries which are able to rectify trade imbalances through foreign exchange adjustments, can benefit from capital account liberalization as it would add for them an alternative route of balancing the current account through flows in the capital account in response to interest rate differentials. They would be able to deploy both monetary and exchange rate policies to attain external equilibrium.

For most African countries, however, trade deficit is a structural problem that cannot be resolved through devaluation as the price elasticity of both export and imports is very low. Liberalizing the capital account under this circumstance, far from providing an instrument for helping to counter-balance trade deficit, can become a factor of macroeconomic instability.

Many economists in Africa are apparently unaware that de facto capital account liberalization has occurred across the continent. This, because currency markets have been legalized, allowing foreign exchange bureaux as well as the public to buy and sell foreign currencies freely which is perhaps the most important aspect capital account liberalization for most of the African countries.

Furthermore repatriation of foreign exchange earnings from exports is being relaxed and not strictly applied in some countries.

With currency depreciation failing to bring about an improvement in the balance of payments, liberalization of the currency market encourages asset holding in foreign exchange, and central banks get obliged to maintain a high interest rate regime, not so much as to attract capital inflow from outside the country as to reduce capital flight from the country. Thus monetary policy losses its autonomy and becomes an appendage to the exchange rate regime, while attainment of macro-stability gets unusually difficult and likely to involve deeper restraint on growth.

Part 3

What is the African experience of financial liberalization in the 1990s? Has it been a success or failure? The response, I think, has to be negative. Liberalization has been accompanied with macro-economic instability evidenced by high inflation rate, sharp exchange rate depreciation, and high interest rates. To be sure, financial liberalization was invariably coupled with exchange rate liberalization, which accentuated macro instability.

Growth of money supply was generally much faster than warranted, it being attributable mostly to an increase in net foreign assets, which in several instances appears to be driven by exchange rate deprecation rather than net domestic assets. Interest rates were persistently kept at high levels, presumably to restrain capital outflow. This is likely to have had an adverse effect on two fronts: promoting paper entrepreneurship and financial dis-intermediation vis a vis the private sector. Hence on the real sector as well, the effect of financial and exchange liberalization is judged to have been negative.