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AGENDA

Conference on Policy Reform and Financial Sector Research in Africa

June 20-22, 1989

The Madison Hotel, Washington, D.C.

Tuesday, June 20 (AM Session)

8:30 - 8:45 Welcoming Remarks by Conference Chair

John R. Westley, Bureau for Africa, A.I.D.

Session 1 The Financial Sector in Developing Countries: Africa's Special Experience

Session Chair: **Jerry Wolgin**, Chief Economist, Bureau for Africa, A.I.D.

8:45 - 10:15 **Millard Long**, IBRD. Oral presentation. Post 1989 World Development Report thoughts on the development of the financial sector in Africa

"Financial Reform Programs in Africa", **Jo Ann Paulson**, University of Minnesota

Discussant: **Steven A. O'Connell**, University of Pennsylvania

10:15 - 10:30 **BREAK**

Session 2 Restructuring of Banking Systems in Distress

Session Chair: **Michael N. Sarris**, IBRD

10:30 - 12:00 "The Collapse of the Banking System in Guinea," ~~Michel Wormser~~, IBRD
ALAIN SOULARD (SOULARD)
Discussant: **Nancy Benjamin**, Syracuse University

12:00 - 1:00 **LUNCH**

Tuesday, June 20 (PM Session)

1:00 - 2:30 "Financial Sector Restructuring in Ghana", co-authored by **M.G. Sri-ram Aiyer** and **Jacque Toureille**, IBRD

Discussant: **Sergei Bortolani**, Finafrica

Tuesday, June 20 continued. . .

2:30 - 2:45	**BREAK**
Session 3	Informal Financial Markets and Linkages to Formal Systems
	Session Chair: **Alan Gelb**, IBRD
2:45 - 4:00	"Informal Financial Markets in Gambia," **Parker Shipton**, Harvard University
	Discussant: **Carlos E. Cuevas**, Ohio State University
4:00 - 5:30	"Formal and Informal Financial Markets: Linkages and Policy Implication", **Philippe Hugon**, University of Paris
	Discussant: **Anand G. Chandavakar**, Consultant
5:30 - 7:30	**RECEPTION**

Wednesday, June 21 (AM Session)

Session 4	Monetary Stability and Financial Markets
	Session Chair: **Donald J. Mathieson**, IMF
8:30 - 10:15	"Financial System Performance and Inflationary Experience in Africa," **Joshua Greene**, IMF
	"Inflationary Impact on the Tanzanian Financial System," **C. Kimei**, Senior Economist, Bank of Tanzania
10:15 10:30	**BREAK**
10:30 - 12:00	"Monetary Stability and the Financial System in the Franc Zone," **Patrick Plane**
	Discussant: **Louis M. Goreux**, Consultant, IBRD
12:00 - 1:00	**LUNCH**

Wednesday, June 21 (PM Session)

Session 5	Non-Bank Markets and Financial Innovation
	Session Chair: **Lawrence H. White**, The University of Georgia

Wednesday, June 21 continued. . .

1:00 - 2:45	"Non-Bank Financial Innovations in East Africa," **Anthony Saunders**, New York University
	Discussant: ~~**John M. Samuels**~~, University of Birmingham David Hearer -
2:45 - 3:00	**BREAK**
3:00 - 4:45	Panel discussion on non-bank financial markets and financial innovation from various viewpoints. What has been tried, what has not worked and what has succeeded? A prognosis of possibilities over the near term.

Thursday, June 22 (AM Session)

Session 6	The Summing Up, Conclusions and the Future of Financial Sector Research in Africa
	Conference Chair: **John R. Westley**, A.I.D.
8:30 - close	**J. Clark Leith**, University of Western Ontario, will present his interpretation, based on the Conference proceeding and papers, as to the priority research activities that are imperative to a better understanding of financial sector development in Africa. After his presentation, the plenary session will review his conclusions and put forward comments and suggestions.

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Participant's List
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M.G. Sri-ram Aiyer	IBRD
Ali Abid Amalow	Somali Central Bank
Brian Ames	USAID, Yaounde, Cameroon
Nancy M. Barry	IBRD
Alan Batchelder	A.I.D.
Melissa Brinkehoff	A.I.D.
Nancy Benjamin	Syracuse University
Phillip Berlin	IBRD
Deepak Bhattasali	IBRD
Edwin L. Bornemann	IMF
Sergei Bortolani	Finafrica, Milan, Italy
Richard Breen	Price Waterhouse
Evangelos A. Calamitsis	IMF
Philippe Callier	IBRD
C. Stuart Callison	A.I.D.
Benjamin Carr	Banjul, Gambia
Anand G. Chandavarkar	Consultant
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Patrick Honohan	IBRD
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Philippe Hugon	University of Paris
Dr. Jerry Jenkins	Sequoia Institute
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Erna Kerst	USAID, Niamey, Niger
Dr. C. Kimei	Bank of Tanzania
Sam LaFoy	A.I.D.
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Promodh Malhotra	IBRD
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Andrew Mullei	Dakar, Senegal
A.B. Ndofor	Cameroon
Frank Nieder	Stanford Research Institute
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Stephen A. O'Connell	University of Pennsylvania
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Jo Ann Paulson	University of Minnesota
Manuel Penalver	IBRD
Patrick Plane	University of Clermont, France
Christiaan Poortman	IBRD
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Leonard G. Rosenberg	A.I.D.
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J. O. Sanusi	Central Bank of Nigeria
John M. Samuels	University of Birmingham, England
Michael N. Sarris	IBRD
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Parker Shipton	HIID
Jane Siefert	A.I.D.
Emmy Simmons	A.I.D.
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Warren Weinstein	A.I.D.
J.R. Westley	A.I.D
Lawrence H. White	University of Georgia
Ulrike Wilson	IMF
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Michel Wormser	IBRD
Kerfalla Yansane	Conakry, Guinea
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DRAFT

Some Unresolved Issues in African Financial Reforms

Jo Ann Paulson
University of Minnesota

A quick survey shows that many African countries have started or will have to start financial reforms under adjustment programs. This is not surprising since the banking systems had been integral parts of the economic systems now under stress and reform. Many countries have found that weak financial systems were not providing efficient financial services to facilitate structural adjustment efforts. The strength of this perception and the underlying causes of the problem vary across the continent. Generalization violates the diversity of Africa, but several issues seem common. The thin segmented financial systems have been operating within distorted economies under perverse regulations and incentives. Financial systems mirror the problems in the broader economy and usually reflect the weaknesses or strengths of the general development strategy. The banking systems were vulnerable to international shocks and the downturn in domestic performance in the early 1980s. Many African banks saw portfolio quality continue to deteriorate as the economies undertook structural adjustment programs including sharp devaluations and reducing budget deficits. In addition, the systems have been affected by international forces that triggered instability and adjustment in financial systems around the world.[1]

A stylized representation of the structure and incentive framework of African financial systems would include the public development banks or financial parastatals, private and public commercial banks, curb or

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[1] e.g. the effect of the appreciation of the franc relative to the U.S. dollar on the franc zone countries. Other trends in international financial markets largely bypassed the African countries: greater integration among the capital markets of industrialized countries; dynamic interplay between market innovation and reregulation; and the move towards universal banking.

parallel markets, and informal credit markets.[2] The mix of institutions and ownership varies by country from total public control to mixed formal systems and from thin to fairly sophisticated informal systems. The development finance institutions, and the public commercial banks in some countries, have been assigned a highly politicized role in dispensing government or donor funds at subsidized interest rates to public enterprises or a select private-sector clientele. From the beginning these institutions had lax incentives for information gathering, credit appraisal and collection and frequently no flexibility to innovate. The incentive structure and lack of accountability in many DFIs led to concentration of lending and poor repayment, as seen all over the world in similar institutions. Non-depository DFIs were dependent on the continuing inflow of new funds so the shortage of government or donor funds in recent years has compounded the problems of poorly-performing portfolios and insolvency with illiquidity.

The commercial banks, private domestic, foreign and public, have been subject to interest rate restrictions, differentiated refinance schemes[3], implicit or explicit credit guarantees for lending to public enterprises, and sectoral credit guidelines to try and force banks to accommodate the government development strategy and become more exposed in the 'priority sectors'. There is considerable variation in the operation of public commercial banks. In some countries these operate more like DFIs than commercial banks and are now carrying a significant burden of nonperforming assets. There are also cooperatives banks operating in several countries: Kenya, Uganda, Rwanda, Zaire, and Mali.

Curb credit markets do not seem to play a major role in Africa although it seems likely that the countries with the most perverse regulation but less government control have developed some form of parallel credit markets. Many countries have active curb markets within immigrant communities e.g. the South Asians in East Africa and the Lebanese in West Africa.

All African countries have some type of deposit facilities, such as a Post Office Savings Bank, spread throughout the countryside and this may be the only formal financial institution used by the majority of rural residents. Credit and insurance functions for the majority are left to family or social networks through informal markets. Rotating savings and credit clubs are found in many parts of the continent. There are moneylenders in some areas and so-called 'mobile bankers' for small enterprises in the markets of West Africa e.g. the susu market in Ghana. Informal systems might be able to handle consumption credit and small investments, but are rarely able to move into lending for larger investments. Some institutions in the informal markets have been

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[2] There are formal securities markets in Kenya, Nigeria, Cote d'Ivoire, and Zimbabwe, but only Zimbabwe is fully-functioning.

[3] particularly in West Africa

suppressed e.g. many governments monopolized marketing systems drying up shopkeeper and supplier credit. For example the government of Malawi shut down the small Asian shopkeepers in rural areas.

It is not surprising that the thin segmented highly-regulated and distorted formal financial systems were vulnerable to the downturn in economic performance in the early 1980s. Government regulation of the formal institutions and the availability of donor funds had given little incentive for resource mobilization, directed credit allocation had not been guided by efficiency of resource use, there had been few incentives for market development, reducing segmentation or increasing efficiency. The burden of directed credit to government parastatals and the weight of bad debt in the financial system became more evident with the shortage of government funds in the 1980s.

Early Reform Efforts

Nationalized Banking Systems

Several countries with nationalized banking systems[4] are in the process of dismantling or reforming the systems which used banks as an extension of the state budget to allocation resources: Mozambique, Madagascar, Guinea, Tanzania and Angola. Several have had problems with system-wide instability. The reforms in Guinea and Madagascar involved restructuring and partial privatization with partial foreign ownership. Mozambique, Tanzania, and Angola are breaking up the large government banks.

The Guinean banking system collapsed in 1985 and has been restructured with foreign partnerships but evidently the restructuring as not been sufficient to restore credibility to the system. (see WDR p. 107)

The portfolio quality in the three state banks of Madagascar deteriorated after 1985/6 when the government transferred the losses of public enterprises to the banking systems to comply with the public deficit ceilings of an IMF program. Moderate reforms started in 1985 with liberalization of most interest rates to increase bank earnings to cover administrative costs and start provisioning for loan losses. All three state banks in Madagascar are now operating as a cartel to raise earnings to cover the cost of provisioning the overhang of potentially bad debt. The three state banks are being restructured and the

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[4] Tanzania (1967), Somalia (1970), and Guinea (??) nationalized the banking systems at independence. The banks of Ethiopia have been nationalized since Jan. 1975, in Madagascar since 1975, and in Angola since 1976. While Mozambique took over and consolidated the Portuguese banks in 1978????, a private bank, Banco Standard Totta de Mocambique, was allowed to remain.

government plans to sell part of these banks to foreign partners. A new banking law in 1988 permitted private and foreign banks to enter. There has been at least one very small de novo foreign bank established. The steps now under consideration are improving the supervision of the Central Bank, removing the preferential discount rate for agriculture, standardizing the reserve requirement, getting rid of prior authorization by the Central Bank for large loans, and removing Central Bank personnel from the management boards of the commercial banks.

The financial system in Tanzania has stagnated and become a problem for the on-going reforms in the real sector. The banks are carrying bad debts of the agricultural marketing boards and the industrial parastatals and are technically insolvent. In the past the banks have depended on infusion of government and donor funds and are not functioning as intermediaries so there is little hope for reviving the system without restructuring and recapitalizing both the commercial and development banks. In --- 1988 Tanzania established a commission to consider the options for dealing with these problems and for financial sector development. Among other issues the commission is considering ways to break up the largest commercial bank, NBC, how to establish equity markets within a socialist economic framework, how to use long-term funds from provident fund for investment, etc. As reforms progress the DFIs will also need to be restructured and diversified, banks supervision improved, and agricultural marketing reformed to reduce the burden of financing marketing credit.

Mozambique has been transferring public enterprise lending from the banks to the budget and has liberalized interest rates, although rates remain negative under high inflation. The state has started to restructure the banks with the government slowly taking over the arrears of public enterprises and the banks will need to be recapitalize. While the major commercial bank in Mozambique will remain under government ownership, the remaining private bank in Mozambique is gaining market share to provide some competition in the system.

Angola started planning financial sector reforms about two years ago. The large government bank will be broken up into a Central Bank and several commercial banks. There is also one savings bank with rural branches. Interest rates will be raised to mop up the excess liquidity in the system.

There have not been significant financial reform efforts to date in Somalia, and Ethiopia.

Mixed Banking Systems

Most African countries have mixed banking systems with foreign, private, and public banks. All have been subject to some degree of repressive regulations but with a great deal of variation across the different macroeconomic policy and enforcement regimes. These systems

are typically dominated by one government-owned and three or four large foreign banks. Many of these countries have seen the entrance of new banks or non-bank financial institutions since 1980, but increasing the number of institutions has not necessarily expanded the range of instruments or services. Most commercial banks, whether foreign or domestic, limit risk exposure in the economy, minimize the damage of interest rate restrictions and credit allocation guidelines by focusing on fee income from foreign trade and exchange transactions rather than intermediation, restrict competition by implicit or explicit collusion, and provide limited services to a select clientele. Lack of competition in banking shelters profits on some activities, while interest rate restrictions, sectoral credit guidelines, and bank credit ceilings discourage domestic intermediation, diversification, or innovation. Most of these countries also have DFIs and financial parastatals to provide term credit for 'priority sectors' and seasonal credit for agriculture. The DFIs tend to be highly politicized and the commercial banks have not been immune to the pressure to lend for political or 'development' as well as commercial reasons.

A few of the mixed banking systems, e.g. Zimbabwe, Nigeria,[5] and Kenya, have expanded the range of services and contracts available with the commercial banks and have some other services available through wholesale, investment, and merchant banks, non-bank financial institutions and leasing companies. The range of contracts and services available to middle and smaller enterprises is limited. These countries still have a very limited range of money and capital market instruments and institutions. Improving the supervision capabilities of the Central Bank is a priority since these systems will be vulnerable to the risks of more developed financial markets with new entry, innovation, and off-balance sheet risk, which is reportedly already a problem in Nigeria. Nigeria has looming problems in some undercapitalized financial institutions, especially the state commercial banks. The country has already begun to reduce some of the restrictive regulations on banks, such as reducing the unenforced system of sixteen sectoral credit allocation guidelines down to two sectoral guidelines of 15% to agriculture and 40% to manufacturing. Nigeria is expected to undertake further financial reforms in the near future. Kenya had problems with the growth of the less-regulated fringe of new banks and non-bank financial institutions in the mid-1980s and has seen undertaken a financial reform program including reregulation and strengthening the supervision of the Central Bank. Both Nigeria and Kenya have introduced deposit insurance schemes.

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[5] Nigeria had a banking boom in the 1940s and early 1950s with the entrance of several indigenous private banks. Most were troubled by high loan losses and forced to close. In 1976 the state took a 60 percent equity share in the expatriate banks but left management policy with the expatriate shareholders. Since that time all financial institutions must be at least 60% owned by Nigerian nationals.

The intermediate range of banking systems, such as Mauritius and Botswana, are fairly profitable but are not evidencing much innovation. Botswana has just introduced some financial sector reforms with assistance from the World Bank. The challenge is to use the high level of international reserves constructively to reduce the extreme dualism in the economy and develop the financial system. Botswana is also unique in several other respects: there are two established British banks and one newer foreign bank but no government banks; the country has a successful DFI that is now spinning off a stock brokerage and unit trust; and rural informal credit markets are reportedly extremely thin because of the preference for holding savings in cattle.

Mauritius is undertaking a cautious program by liberalizing interest rate restrictions and lifting credit ceilings. The market interest rate did not move much after liberalization, evidently because there is little competition and excess liquidity in the banking system.

There are some countries with a fair number of institutions but very little competition or development in banking. Zaire and Zambia, both with volatile mineral exports and macroeconomic performance over the last twenty years, evidence this pattern. Zaire started and then abandoned reform programs in 1981 and again from 1983 to 1985 which included liberalizing interest rates and other financial regulations. Government has maintained significant controls on credit allocation. There have also been periods when very high reserve requirements led to financial disintermediation and in the last few years there has reportedly been significant direct political pressure on credit allocation. There is very little competition in banking services or in the inter-bank exchange rate auction among the nine commercial banks. Intermediation is not very lucrative but the banks are profitable because of commission fees and foreign exchange transactions. One private bank failed in 1988 but is still being operated by the government and several DFIs are now insolvent. The Government of Zaire has recently negotiated another reform program with donors including financial sector reforms.

Zambian banks operate as a banking cartel and have maintained conservative lending practices. The banks did very well under the radical economic reforms from 1985 to 1987 for several reasons. Even though interest rate restrictions were reimposed several months into the reform program, the spread was considerably higher than before the reforms. Much of the lending is to public enterprises, and the public enterprise sector became more profitable under the reforms. The banks earned healthy fees in managing the foreign exchange accounts of exporters with foreign exchange retention privileges. There do not seem to be serious credit-quality problems in the banks under current economy policies, but there is concern that the Central Bank can not adequately supervision the commercial banks.

Malawi and Rwanda are examples of mixed banking systems with few financial institutions and strong government presence. The Government of Rwanda has at least 50% ownership in all commercial banks and

majority share in all development banks. Both the commercial banks in Malawi are primarily owned by the quasi-public holding companies. With government encouragement, in the past much of the commercial and development bank credit went to subsidiaries of the holding companies and for a period, to tobacco estates. While there is still bad debt in the Malawian banking system from the early 1980s, the system is considered sound. The problems are inefficient intermediation, lack of an adequate supervisory framework, and limited service to medium and small enterprises.

The mixed banking systems of Uganda and Ghana are both evidencing financial distress following decline in the economies since the 1970s. Uganda undertook a structural adjustment program in 1987 and some credit reforms in 1988. Two new banks have opened recently as have several new non-bank financial institutions so there are now six NBFI. Central Bank supervision of the fringe institutions has been very weak and there has been a case of fraud in a new NBFI. More attention is being devoted to the insolvent state Cooperative Bank.

Ghana started financial reforms as part of a comprehensive structural adjustment program in 1983. The program used discrete adjustments to gradually liberalize financial regulations and introduced a few new instruments and institutions. The banks are now being restructured. Response in the sector to new regulations seems to be slow and confidence has not been restored yet. The Government of Ghana is undertaking a financial sector project with the help of the World Bank to strengthen the banking system.

Mauritania is restructuring the banking system with recapitalization, and privatizing. There are problems in nine of the 15 banks.

Swaziland and Lesotho have small financial sectors. There are problems in DFIs but no threat to stability.

Sudan also has a mixed banking system,[6] but Islamic banking was imposed in 1984. There are five Islamic banks in Sudan and all other banks are to operate under Islamic practices. It is not clear that banking practices have changed dramatically under Islamic banking. The Central Bank is attempting to move towards tighter regulation and has established a committee to investigate illegal activities.

There have not been any financial reforms in Sierra Leone.

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[6] Sudan nationalized all banks in 1970 but foreign banks have been permitted to operate since 1976.

The Franc Zone

West and Central African countries in the franc zone[7] have mixed banking systems with a significant foreign presence. Typically the foreign and private commercial banks serve foreign and more profitable domestic companies. The larger firms can also purchase financial services in France. All these countries also have development banks designed to serve some niche in financial markets e.g. indigenous enterprises or term lending.

Regardless of the number of banks, e.g. small financial sectors in Benin and Cote d'Ivoire to a fair number of banks in Senegal, the financial systems do not seem to be developing efficient systems of intermediation.[8] The incentives for deposit mobilization have been low and the banks remain dependent on central banks discount facilities for liquidity. The governments have intervened extensively in credit allocation and BCEAO sets differentiated discount rates for priority sectors.

These financial systems are burdened by bad debt, most have several insolvent financial institutions, and some are even threatened with instability in the system. Some systems, e.g. Mali, Cameroon, Senegal, Benin, face bad debts from the state-owned enterprises with the governments poorly prepared to meet the contingent liabilities of state credit guarantees for failed enterprises.[9] There is also the problem of bad crop marketing credit.

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[7] Benin, Burkina Faso, Cote d'Ivoire, Niger, Senegal, Togo, and Mali (since 1984) from the Union Monetaire Ouest Africaine (UMOA) and Cameroon, the Central African Republic, Chad, Congo, Gabon and Equatorial Guinea (since 1985) in the Banque des Etats de l'Afrique Centrale (BEAC)

[8] For example Senegal has 14 commercial banks and six other financial institutions but very little competition, low profitability, weak financial discipline, and credit allocation is directed by the government.

[9] In Benin, borrowing of state-owned enterprises accounted for more than one-third of outstanding domestic bank credit and 13 percent of GDP in 1986. When much of this credit became nonperforming, it created central government contingent liabilities to the domestic banking sector ten times larger than the direct net budgetary transfers from government to nonfinancial state-owned enterprises. This virtually paralyzed the banking system and put heavy demands on future government budgets. Similarly, when the former state agricultural marketing board in Senegal was liquidated in 1980, the government had to assume bank debts equivalent to 15 percent of GDP. (World Bank, World Development Report 1988, pp. 170)

Several of these countries have agreed to consider financial sector reforms, but to date there has been no progress on issues of operations of the Central Banks and the currency zones e.g. slippage in the supervision of the Central Banks and the enforcement of the regulations by the governments.

Early Lessons from Financial Reforms

Initial stages of financial reforms have been harder and slower than expected three or four years ago. There are several reasons for this: the initial conditions were bleak; the portfolio quality was worse than originally believed and has continued to decline in many countries; the need to audit clients as well as banks to identify bad debt; the shortage of trained bank and accounting personnel; and lack of domestic or foreign interest in the banks to be privatized. But the problems have not been just in implementation. There are a host of difficult unresolved issues on financial reforms.

Unresolved Issues and the Role of Research

The diagnosis of past problems has not been that different than found in other parts of the world. Reducing perverse government intervention and liberalization is an essential part of reforms. But there are still a host of unresolved transitional and structural issues about how and when and to what extent the government should disengage. Liberalization is not enough to guarantee safety and rebuild credibility in weak financial systems or institutions; liberalization is not enough to drive financial systems towards efficiency when there is little competition; liberalization may be destabilizing or may be swamped if not coordinated with macroeconomic reforms; but perhaps most importantly, governments are not convinced that liberalized financial systems will address the development needs of the countries, serve a broad clientele, or generate enough innovation to develop the financial systems. These issues will be central to the decision about how, if, and when the government will disengage from micro-controls on the financial system during the early stages of reforms.

Confronting these concerns about liberalization is more difficult because we don't know what an optimal financial system would look like in African societies. The objectives can't be that different than in other countries, such as efficiency of intermediation and information processing and payment services, filling out the range of instruments and contracts, reducing segmentation, redirecting resources to efficient uses, etc. However those objectives provide little guidance on institutional structure, contract forms, etc. In time market forces might reveal some of this information but the large gaps left in these segmented systems as governments disengage is generating pressure for direct intervention to establish new institutions and instruments and lending schemes. The push to rebuild the financial systems quickly leaves little time for market forces to push the systems toward viable institutional forms. Unfortunately we don't know much about the alternatives or options It would be much easier to restructure and

reregulate African systems with long-term solutions to guide and discipline short-run decisions. Instead there is a danger that short-run choices will constrain the long-run options.

Research can not resolve the issues listed above. However, research on financial systems may help to document the success or failure of financial experiments, clarify the options, and narrow the range of controversy. The following outline of some proposed research topics is heavily weighted towards the countries with very weak financial systems emerging from strong government dominance.

I. Coordination of Macroeconomic and Financial Reforms

Experience in Asia and Latin America showed that it is extremely difficult to manage financial reforms and liberalization of the economy without macrostability. Many African countries are finding that macrostability is illusive and there have been recurrent bouts of inflation. Is this an argument for maintaining a full arsenal of government controls and keeping administered interest rates during the transition?[10] It is still early for detailed analysis on the reform efforts in Africa, but there is enough information to begin comparative work on the various strategies used to coordinate macroeconomic and financial reforms. For example, Zambia undertook a radical reform program in 1985. The financial system was completely liberalized for a few weeks until the Central Bank lost faith in the Treasury Bill auction and gradually introduced more restrictive regulations on the banks over the remaining 18 months of the reform program. In contrast Ghana used discrete adjustment to raise nominal interest rates and reduce restrictions on the banks over several years before decontrolling interest rates in 1988. Guinea and Mauritania restructured the banking systems early in the reform programs while Ghana started liberalizing and reregulating before restructuring. There may also be enough information to begin analysis on attempts to change monetary control regimes, establish interbank markets, Treasury Bill auctions[11] or new money market institutions, and alternative strategies for liberalization.

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[10] Several countries have liberalized but not decontrolled interest rates: Mozambique, Madagascar, and Zambia. Malawi and Ghana, among others, adjusted nominal rates over several years and have now completely liberalized interest rates. Real interest rates in Ghana remained negative even after total decontrol.

[11] Some countries have introduced limited Treasury Bill auctions e.g. Zaire in April 1983, Kenya, and Ghana. Zambia introduced a Treasury Bill auction in Sept. 1985 but abandoned the system after a few weeks because of skepticism about the interest-responsiveness of financial savings and the fiscal burden of higher interest rates on domestic debt servicing.

II. Imperfections in Financial Markets

Some of the strongest arguments for past government intervention were significant imperfections in financial markets such as missing markets and market power among foreign financial institutions, as well as imperfections in other markets in the economy. These imperfections are still seen as significant obstacles to liberalization.

Because reform efforts are so new there is little experience dealing with the types of imperfections found in Africa. The question of direct government intervention to try and establish markets will be discussed in the section on financial innovation, but several common issues under debate can be listed here. Should the governments establish equity markets or allow the commercial banks to take equity positions? Are units trusts or universal banks viable options? What do missing equity and insurance markets mean for operation and regulation of other parts of the system? Should the government retain directed credit programs?[12] What does market power in banking mean for regulation and macroeconomic policy?

Implicit or explicit collusion is common among the commercial banks in Africa e.g. Zambia, Botswana, and Zaire, and this behavior is not limited to the mixed banking systems. All three state banks in Madagascar reportedly have been operating as cartel since 1985 to generate sufficient earnings to cover the high costs of provisioning potential losses. Liberalization may increase the incentives but does not guarantee competition. Will interest rate flexibility stimulate competition? During the brief period of interest rate liberalization in 1985 in Zambia, the banks did exhibit some competition on interest rates but the banking cartel continued to adhere to a uniform schedule for fees.[13] Can the government stimulate competitive behavior through lowering barriers to entry, encouraging multipurpose banks, changing the institutional mix, or reducing restrictions on allowable activities among types of financial institutions? It is not clear that encouraging entry or increasing the number of banks will stimulate enough competition to encourage efficiency or innovation. Kenya demonstrated the potential for instability with the failure of six financial institutions with low entry barriers to stimulate competition from non-bank financial institutions and small indigenous banks. How much control over taxation and discretionary regulation should be left with the Central Bank if the banking sector does not develop more

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[12] It was interesting to note that the WDR allowed for the possibility of using directed credit if the macroeconomic framework was not terribly distorted. (WDR p. 60)

[13] Another lesson from Zambia was that interest rate liberalization led to higher spreads on loans to the same customers. The banks did not expand the client pool or lend to different sectors.

competitive behavior within a few years after liberalization? What regulatory powers should be left with the Central Bank in the systems dominated by a single financial institution.[14]

III. System Stability and Credibility

In some countries the credibility of the financial system was totally eroded before beginning reforms. Experience with restructuring in Guinea or reducing restrictive regulations in Ghana did little to reestablish credibility. There is still not sufficient credibility in the policy framework to change the behavior in financial institutions or enough confidence so that the public takes advantage of intermediation services.

There are good reasons why the public is showing caution in dealing with these systems. Not only will the financial systems be vulnerable to macroeconomic policy changes as governments grope towards workable economic systems, also these are small banks operating in poorly diversified weak economies under closed capital accounts[15], and deregulation, liberalization and new entry are going to add other dimensions of risk. Stronger regulations and supervision are essential, but even well-formulated prudential regulation[16] backed by stronger reporting, supervision, and inspection systems won't eliminate the potential of bank failures.

The erosion of financial discipline in the formal, especially government, institutions is going to make it very hard to establish credibility about the safety and soundness of financial institutions. It remains to be seen if a period of financial stability will slowly rebuild confidence in the more distressed African systems even if the government does not explicitly establish deposit insurance. In some countries it may be necessary to develop explicit government protection to reestablish credibility. There has not been much research on alternative government policies for dealing with potential instability or what the alternative policies would mean for the structure of the financial system. Does the government want to introduce a deposit insurance scheme covering all institutions or just some institutions or

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[14] For example, BDM has about 70% of the total assets of the financial system of Mali, and the development bank BDRN in Niger has 60-70% of total loans and 45% of total assets, and the National Bank of Commerce controls over 95% of the total short-term credit in Tanzania.

[15] except Gambia and the currency zone countries

[16] Many of the issues that will need to be addressed in reregulation for safety could benefit from comparative African research e.g. the relationship between portfolio risk and permissible activities, portfolio diversification under closed capital accounts, management of foreign exchange risk, regulation of off-balance sheet risk, and interest rate risk under inflation.

only attempt to stabilize the whole system while allowing individual institutions to fail without depositor recourse? Can the international banks help stabilize the system?

In a few countries the international banks are seen as offering a degree of implicit insurance. After the bank and non-bank financial institution failures in Kenya there was reportedly a shift in the deposit base to the large foreign banks. Is it safe to assume that depositors get de facto deposit insurance in large foreign banks?[17] Once interest rates are liberalized can we assume that depositors who use the newer and probably more risky deposit facilities to earn higher deposit rates are revealing their tolerance for risk. Should this assumption be made explicit? Would this solution be politically acceptable to government trying to encourage indigenous institutions?

Kenya and Nigeria have established deposit insurance schemes modeled after the U.S. Federal Deposit Insurance Corporation. It is not clear that this type of blanket guarantee to financial institutions is desirable because it can be very expensive and removes the incentive for market discipline. The U.S. is trying to supplement the deposit insurance scheme with other measures to discipline risk-taking in financial institutions e.g. risk-based capital standards and disclosure laws[18]. These supplementary measures may strengthen the system but cannot prevent banks failures because banks can disguise weakness. Governments may have to be more explicit in setting the rules for depositor protection before there can be much progress on establishing credibility.

IV. Development Objectives

It is easy to generalize that directed credit programs for 'development' purposes through DFIs, or sectoral credit guidelines for commercial banks, or specialized credit programs are inefficient instruments of development, have distorted the financial markets, have funded the adoption of inappropriate technology, and benefits have been very concentrated. But these generalization provide little insight for addressing the legitimate concerns of government that liberalized

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[17] It is not clear whether selling partnerships to foreign investors as in Madagascar and Mauritania will help to establish credibility. The presence of foreign banks did not seem to be enough to establish credibility in Guinea.

[18] There may not be much potential for market discipline of risk-taking in the commercial banks in Africa except by the corporate sector. The use of market discipline works better in system with institutional investors disciplining stock prices for banks. The public rarely has enough information to evaluate the risk of banks even if the Central Bank discloses bank penalties.

private banking systems, especially with foreign banks, will not fund indigenous enterprises or extend service to the general population. These concerns will surface very quickly in the debate on the fate of DFIs and regulations on the involvement and exposure of commercial banks in the domestic economy.

DFIs usually serve a very small clientele with concentrated benefits but governments are hesitant to dismantle or privatize the DFIs because these may be the only financial institutions providing finance for domestic firms or term credit. Many countries are evidencing a marked preference for not disengaging from ownership, especially since this usually means sale to foreign concerns, and may chose instead to only disengage from micro-management. As governments evaluation their options on degree of disengagement, it would be helpful to study the few successful DFIs, e.g.------- in Zimbabwe and the Botswana Development Corporation.[19] Can a government institution be held accountable to commercial standards and maintain autonomy in management and enforcement procedures? Can the bulk of DFI lending be done on commercial terms with subsidies limited and made transparent? If there is little hope of maintaining autonomous management of the DFIs, how should the institutions be privatized?

Another set of issues emerge from concerns about increasing access to financial services. This has not only led to the proliferation of specialized or subsidized credit programs but also used as justification for interest rate restrictions, lowering minimum balance requirements, and rural branching requirements[20] for the commercial banks. Banking systems are seen as one potential link between small enterprises and smallholders and the broader economy. There is little question that access to financial services in the less developed parts of the economy would increase welfare, but at what cost? When do high transaction costs and the lack of collateral-substitutes suggest that credit could be handled more efficiently through the informal system and deposit facilities through the post office system rather than through banks?

There are very few models of viable formal rural financial institutions

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[19] The Botswana Development Corporation has reportedly established the Sechaba Investment Trust and Stock Brokers Botswana Ltd. to facilitate privatizing of some of its profitable corporations. (cited in WDR p. 62)

[20] Both Kenya or Nigeria have used rural branching requirements on the commercial banks.

in Africa outside the richer agricultural areas.[21] Even a liquid profitable banking system like Botswana has had little success at establishing linkages into the rural or traditional economy. Many of the unit banks in rural Ghana are insolvent. There is a continual search for new models of rural banking institutions, but few success stories so far.[22] Should priority be given to expanding financial systems in areas with viable new technologies, and incentives to adopt that technology because of population pressure, and land titles or leases for collateral rather than throughout the country?

These unresolved issues on broadening access to financial services and use of the financial system to develop the economy need to search out and document experiments on different institutional forms and this is discussed below. It may be found that the commercial bank networks in some countries do a reasonable job of providing financial services in the more developed areas given the regulatory and structural constraints and high transactions costs. It may also be found that transaction costs are so high in some areas of the economy that formal financial institutions are not viable and that the government should encourage shopkeeper and input credit and the informal markets.

V. Institutional Design and Financial Innovation

The pressure is mounting for supply-side initiatives since the financial sectors in many countries are incapable of participating in structural adjustment, there are gaps left by insolvent financial institutions, governments have little faith or historical experience with private-sector initiatives, and donor agencies need to be activist, or at least responsive, to government requests for policy options. It is relatively easy to identify gaps in financial markets and draw up a list of instruments and institutions found in Asian and Western financial markets but missing in Africa. But that list

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[21] This discussion focuses on credit and deposit services because these surface more quickly on the policy agenda than other financial services. However, there are other important problems with the weak rural banking system such as the high cost of interregional funds transfers for the rural trading system.

[22] The Banque Populaires in Rwanda is now used as a potential model because it has been successful at mobilizing deposits. However, the administrative and set-up costs of the system were high. (WB, Beyond Adjustment, Pt. II Box 7.3) The Grameen bank model has stirred interest in Africa, as in other parts of the world. Malawi has recently established the MUDZI scheme on the model of the Grameen bank. There are several potential problems with the Grameen model in Africa: the high wage structure for trained personnel in Africa; it may not be appropriate for areas with sparse population density; the operation of the bank has required large subsidies, etc.

doesn't give much insight on priorities or viability of institutions or contracts. In some cases supply-side initiatives may be or may seem to be straight-forward. It seems relatively safe to establish an inter-bank market, even though most institutions in countries now using credit ceilings for monetary control are liquid. It also seems reasonable to start introducing some instruments and contracts for corporate finance. But the new money market institution in Ghana has gotten off to a very slow start because of lack of demand. This supply-side initiative was probably not very expensive and if the institution survives, it may eventually develop a market. But many experiments in institutional design have been very expensive and waste precious human and financial resources.

The real danger is probably that the present push will lead to another generation of imposed institutions, based on the premise that financial markets can be developed by adding institutions and instruments, usually based on models from Asia and Europe. For some parts of the market this strategy should be used more judicially than in the past, but is probably reasonable. For other parts of the financial markets we don't know enough about the options, the alternatives, the demand, and the constraints to design and impose institutions. The biggest failures have probably been in the areas discussed above as the development objectives of governments i.e. introducing DFIs without repayment enforcement and alternative institutions for broadening access to financial services.[23]

The microeconomic approach of institutional economics might be helpful to supplement and balance the current financial market development strategy of imposed institutional design in the areas where little is known about current financial practices. Finance is an institution and the primary function of any social institution is to define the expectations of behavior for individuals operating in the system. Social institutions define the 'rules of the game' governing exchange, cooperation, and competition among individuals and solve the 'assurance problem' to narrow the range of uncertainty.[24] It follows that one of

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[23] e.g. generations of agricultural lending parastatals, the cooperative credit networks, integrated rural development programs, rural development agencies, group lending schemes for small enterprises, savings and credit cooperatives linked to employment, etc.

[24] There is a vast confusing literature on institutional economics, but almost no attempt has been made to apply this literature to financial innovation. This treatment corresponds most closely to the work on institutional innovation by Yujiro Hayami and Vernon Ruttan in Agricultural Development: An International Perspective (Baltimore: Johns Hopkins University Press, 1985) and C. Ford Runge in Institutions and Common Property Externalities: The Assurance Problem in Economic Development (PhD dissertation, University of Wisconsin-Madison, 1981). Hayami and Ruttan define "institutions as the rules of a

the roles of financial institutions in an economy is to set expectations and solve the assurance problem so that agents can engage in financial arrangements.[25] These rules or expectations are essential for credible implicit or explicit or complex financial contracts at all levels of the system, e.g. so depositors can expect to get their funds back under the terms of a deposit arrangement, borrowers know the parameters of acceptable behavior under a lending contract and the penalties for nonrepayment, lenders expect repayment or access to collateral, members of rotating savings clubs expect to receive the joint savings pool in turn, a village shopkeeper cum moneylender expects consumption credit to be repaid at harvest, within family systems an implicit loan scheme to provide tuition and lodging for rural cousins will be repaid by access to family land when urban residents retire to rural areas, etc. Social institutions lower transaction costs for all these exchanges by allowing individuals to form expectation on the rules for cooperative and collective actions.

Induced Financial Innovation

Over time social institutions evolve in response to changing incentives and opportunities e.g. relative prices of inputs and outputs, government policies, technology, knowledge of alternatives, legal structure, etc. Changes in relative prices and other incentives and opportunities create both a supply and demand for institutional change. This approach treats innovation as endogenous or induced by changes in the economy rather than an exogenous or imposed process.

Banking has been in Africa long enough that we would have expected induced financial innovation to adapt financial contracts to local conditions to respond to profitable opportunities for lending or selling financial services. Instead we find commercial banks lending on

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society or of organizations that facilitate coordination among people by helping them form expectations which each person can reasonably hold in dealing with others. ... In the area of economic relations they (institutions) have a crucial role in establishing expectations about the rights to use resources in economic activities and about the partitioning of the income streams resulting from economic activity." (pp. 94-95).

[25] For this discussion an intermediary can be treated as an individual making a series of contracts. The emphasis is on institutions as 'rules of the game' for making financial arrangements, not on intermediaries as a specific financial arrangement. Intermediaries operate over a range of contracts that economize on monitoring and information costs to link borrowers and lenders more efficiently than if agents had to trade directly and provide services such as diversification, information processing, and asset and risk transformation. Intermediaries operate within the expectations held for financial institutions.

a narrow range of contracts and serving only a small circle of repeat clients. Most Central Banks in mixed system believe this is because of conservative banking behavior, lack of competition, and banking cartels. Banks claim it is because of low incentives under interest rate ceilings and repressive regulation.[26] Lack of competition and restrictive regulations certainly have lowered the incentives for innovation, but there are two other dimensions of the assurance problem that have also lowered incentives to innovate: expensive and unreliable information and uncertain enforcement mechanisms on financial contracts

Information systems in Africa tend to be very expensive and frequently unreliable. Tax records are questionable, many accounting and auditing services lack credibility, the land registry is not kept current and land titles and building permits are frequently contestable. Loan appraisal, transaction and monitoring costs are high and the return for information is low. This significantly increases the risk of lending in addition to the conventional asymmetrical information that always arises when the client has more information on the enterprise than the lender.[27] Lenders cannot raise the interest rate enough to cover this uncertainty without increasing the risk of default and the value of the assets pledged as collateral upon default is also uncertain. With weak information systems, lenders (banks) solve the assurance problem by dealing with repeat borrowers or borrowers with government guarantees.

The legal system, another institutional arrangement, defines the penalties and enforcement provisions on financial contracts. Many countries have weak and uncertain enforcement mechanisms on financial contracts with uncertain or contestable property rights on assets pledged as collateral[28] and unpredictable judicial rulings. Given the lack of reliable information on the expected profitability of an enterprise or on the value of the collateral and weak enforcement mechanisms, it is not surprising that commercial banks lend on overdraft facilities to a small group of repeat borrowers in the economy and focus on international trade transactions.

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[26] This is an incomplete explanation in countries were banking laws were not enforced. It also would not explain why financial institutions did not introduce new instruments or contracts to avoid regulations. It is easier to explain why public financial institutions have a poor record at responding to profitable financial opportunities in the societies.

[27] One of the primary functions of financial intermediaries is to gather and process information and make decisions on how much information to gather to reduce uncertainty.

[28] For example, in some agricultural areas traditional property rights on land compete with codified law. (Also, in many countries the dominant or residual property rights lie with the government.)

Many DFIs were not accountable for losses and the 'rules of the game' did not call for loan repayment. The existence of these institutions shifted social norms and contributed to the erosion of financial discipline making it more difficult for any financial institution to solve the assurance problem.

Informal markets usually have an advantage of significantly lower information, transactions, monitoring and enforcement costs to develop contracts suitable for the structure of the local economy. The contracts in curb and informal markets frequently depend on personalized enforcement mechanisms rather than state enforcement.[29] One of the most common arrangements for informal markets are rotating savings and credit clubs based on personalized (peer group) enforcement mechanisms.[30]

It is easy to see how past government behavior has limited financial innovation by lowering incentives and increasing risk of non-enforcement. It remains to be seen if the present round of financial reforms will be credible and succeed in changing macroeconomic and financial incentives enough to induce financial innovation. However, many financial reform programs are not improving information services or enforcement mechanisms by moving beyond banking laws to examine contract law and the predictability of judicial rulings on property rights, and changing expectations about the enforcement of financial contracts. There is clearly potential for dynamic interaction between induced innovation by individuals and imposed institutional change by the state. Individuals cannot innovate state enforcement mechanisms. However, we would expect imposed changes in enforcement mechanisms for

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[29] The erosion of financial discipline and the weak state enforcement mechanisms on private contracts may have restricted curb markets to a very narrow set of contracts. In many countries the curb market operates primarily within immigrant communities where some personal enforcement mechanisms may be available.

[30] There is a great deal of interest in attempts to link formal and informal credit markets in Africa. The problems in the larger organized savings and cooperatives schemes in Kenya suggest that personal enforcement mechanisms can not discipline an impersonal system. It may be possible to link personalized enforcement mechanisms on the local level to impersonal (state) enforcement mechanisms in dealing with banks, but it may be difficult to make state enforcement mechanisms credible against a group. Another problem with schemes that attempt to tap the informal system for savings is that these may destroy the informal networks by driving up transaction costs with government regulations.

contract law or other government actions to reduce risks and costs to create profitable opportunities for induced innovation.

Induced financial innovation is a necessary link between liberalization and development of the markets with new instruments and contracts and expanding clientele. However, institutional innovation has some characteristics of public goods, and therefore the supply from the private sector will be less than optimal. Also induced institutional innovation may be a slower process than can be tolerated in the present policy atmosphere. This means that governments are going to have to stay in the business of imposed institutional changes. The process of institutional design and government-initiated innovation is fraught with uncertainty. Monitoring induced financial innovation, especially at levels of the system that use impersonal enforcement mechanisms, may give important information to guide institutional design[31] e.g. on the demand for financial services, screening mechanisms used under asymmetrical information, and the types of contracts that can be used to solve the assurance problem. Monitoring financial innovation will be especially important before attempting institutional design for rural financial markets. Many past designs have not given sufficient attention to structural or cultural characteristics, such as incomplete or missing markets for risk-sharing and insurance and traditional property rights. For example, while there are complex contracts e.g. sharecropping or other arrangements linking labor, credit, and land in some areas of Africa, these seem to be more prevalent in land-surplus and newly settled areas. If the traditional property rights system grants user rights, this makes it difficult to establish a rental market for land and limits the options for complex credit contracts. It will also be important for financial arrangements when there is very little information such as the liquidity management practices of middle-income households, medium-size businesses, etc.

Conclusions

Many countries have started financial reform programs and many more have looming problems in their financial systems. The initial stages of reforms will cut deep into the established resource allocation patterns and development strategy of these countries. Governments may be hesitant to disengage given the uncertainty about the benefits of liberalized systems. The benefits of financial sector reforms, like the benefits of structural reforms, will take time to become evident.

The information and research base on reform issues in Africa is so weak that research can contribute little to the policy debate. I have

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[31] Monitoring financial innovation also provides information on potential instability in the system from perverse innovation. This is especially important in the more vigorous private systems such as Nigeria, Kenya, and Zimbabwe.

focused on five unresolved issues where there seems to be potential to begin research: coordinating macroeconomic and financial reforms; alternative strategies for dealing with imperfect market structure, including missing markets and lack of competition; stability and credibility under reforms; development objectives and expanding access to financial services; and use of information gathered from induced financial innovation to aid in institutional design. Given the difficulty of these unresolved issues, the time needed to develop competition and build credibility and fill out the contract space through innovation, these issues are going to be on the policy agenda for many years.

RESTRUCTURING OF THE BANKING SYSTEM

IN GUINEA

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Restructuring of the Banking System
in Guinea

1. Background

1.1 In a referendum held on September 28, 1958, Guinea, alone among the French colonies in West and Central Africa, rejected membership in the newly established French community and asked for immediate and total independence. Independence was formally proclaimed on October 2nd 1958. France broke relations with Guinea and suspended financial and technical assistance to the country. Guinea ruler Sakou Toure then turned to the communist bloc for a model of economic development and for assistance. During an interim period, however, Guinea remained in the French Franc Area and the French banks established in Guinea continued operations on a limited scale - Guinea formally left the French Franc Area on February 27, 1960, with the establishment of a Special Monetary Area (Zone Monetaire Speciale), the transfer to the newly established Bank of the Republic of Guinea of the functions of the Institute of Issue of West Africa and the issuance of a new currency the Guinean franc to replace the CFA Franc. All the commercial banks were formally nationalized on August 11, 1960, and their functions taken over by the Bank of the Republic of Guinea, which for several months operated as the Central Bank and the only commercial bank of the country. In March 1961, the Bank of the Republic of Guinea was divided into four specialized institutions, a central bank (BCRG), an agricultural bank (BNDA), a foreign trade bank (BGCE), and a bank for trade, industry and housing (CNCIH). Three more specialized banks were established between 1977 and 1983. Annex I provides a chronological list of the main events which affected the evolution of the Guinean banking system from 1958 to 1986.

1.2 Under President Seko Toure the Guinean economic system was based on central planning, state ownership of the means of production and rigid state control of prices and wages. The authorities' commitment to the Soviet model, however, did not incompass the bauxite and alumina sectors which were permitted to operate autonomously under foreign management. This mining "enclave" included two joint ventures between the government (49%) and foreign share holders (51%) which accounted for more than three quarters of the production of bauxite and all the production of alumina (BCG and Friguia). The other producer of bauxite (OBK) was fully owned by the state but managed by USRR technicians. The authorities did not follow the same policy with regard to diamond mining. The two foreign companies in operations at the time of independence were nationalized in March 1961. The state enterprise which succeeded them was less than successful and halted all production in 1973. As a result of this failure, together with a decline in official agricultural exports, the bauxite (including alumina) sector became, for all practical purpose, the only official source of foreign exhange for the country outside foreign aid. It accounted for more than 95 percent of the total export proceeds in the late '70s and the early '80s (Table 1).

TABLE 1

Guinea: Bauxite and Alumina Exports as a Percentage of Total Official Export Proceeds

1979	95.4	1983	97.9
1980	96.7	1984	98.4
1981	98.7	1985	96.5
1982	96.4	1986	84.2

Source: IMF

The bauxite sector also provided a major share of the government revenues in the form of various tax payments, which represented between 20 and 40 percent of total government income from 1982 to 1985 and jumped to over 80 percent in 1986 as the devaluation of the Guineau franc increased significantly the countervalue in local currency of the tax payments made in foreign exchange by the mining companies.

1.3 While the Guinean authorities left the bauxite mining sector undisturbed, their attitude vis a vis the private sector, for most of the period under review, ranged from reluctant toleration to outright hostility. By law, all land was owned by the state although the private farmers and their families retained a permanent right of use of the land they were cultivating. Land user's rights could be transferred outside the family only with the approval of the local head of the Party-State organization (PRL). Following independence, the government's agricultural policy was oriented towards collectivization and mechanization of production, but successive (and costly) experiments to achieve that objective met with failure. In practice, the bulk of agricultural production in Guinea continued to come from small farmers who did not benefit from the government's investments in the sector but were required until April 1981 to sell a certain quantity of their production to the local Party-State organization (Pouvoir revolutionnaire local) at official producer prices. Faced with increasingly unrealistic producer prices, small farmers survived through a mixture of subsistance farming, clandestine exports (and imports) in border areas and sales at unofficial prices on the parallel market.

1.4 At the best of time, private enterprises outside the agricultural sector were considered with suspicion. From 1965 to 1979, they could not be granted any credit by the banks and under a 1964 legislation, were subject to

confiscation for "illegal profiteering or enrichment." The repressive attitude of the authorities culminated in 1975 with the prohibition of all private trading, including on village markets. The ensuing tightening of government control to prevent a shifting of the distribution of goods to the parallel market led to increased shortage of basic goods and the widespread discontent which resulted in the so called "revolte des menageres" in Conakry (housewives uprising) in 1977 and to the government's retreat from its extreme position. Private trading was again tolerated and the authorities somewhat loosened their grip on the economy. Starting in 1980-81, a reappraisal of the economic policy followed since independence led gradually to a retrenchment in the role of the public sector and a strengthening of the private sector. In the agricultural sector, the marketing quotas were replaced in April 1981 by a development tax and private traders were permitted to buy agricultural products from farmers and resell them to consumers. The five sectorial holding companies which grouped all public enterprises were closed. Import by private firms without purchase of foreign exhange from official sources was permitted. A privately owned commercial bank operating in accordance with Islamic law was granted a license and started operations in 1983. A few months later, in January 1984, a new government owned bank was established to finance the activities of the private sector.

1.5 To sum up, the Guinean economic system was based on a three tier organization. The first tier, which consisted of the bauxite sector, was able to operate without government interference and provided the country with over 95 percent of its official export revenues and over two thirds of the total export revenues, official or not; it absorbed about one quarter of the total imports of the country to meet its operational needs (equipment and raw material) and the needs of its workforce. Its foreign exchange surpluses were transferred to the second tier, consisting of the government and public

enterprises, in the form of tax or other payments. This enabled the government to pay for its expenses abroad (embassies, debt servicing, services), for official imports of material and equipment for public enterprises and for import of basic consumer goods, which were supposed to be sold at regulated prices and were often subject to rationing. On the export side, the contribution of the tier was negligible. The third tier consisted of the private sectors with a formal and an informal (underground) component, the respective size of each component depending to a large extent on the government attitude vis a vis the private sector.[1] It accounted for more than 25 percent of total exports ($100 million in agricultural exports and $60 million in gold and diamonds) and for maybe half the import of consumer goods. Transactions were generally in cash and, in some cases, in foreign exchange. The wide gap between the official and the parallel market exchange rates (1 to 6 in 1983) as well as between the regulated and the unofficial price of many goods resulted in leakage between the second and the third tiers and provided public sector officials with many opportunities for profits. An IMF estimate shows for 1983 in the public sector an average monthly salary equivalent to US$ 50 at parallel market rate and an average monthly income in the sector equivalent to US$ 200, the difference coming from "second-jobs, income in kind or other sources."

1.6 The new orientation toward liberalization of private economic activities, which the Sekau Toure's government initiated in 1980 was half-hearted and expedient in nature. By 1984 it had not gone very far as entrenched interests, bureaucratic inertia and the weight of the regime's ideology and

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1 Repression of alleged political or economic crimes was severe. Out of 71 ministers and state secretaries who served between 1958 and 1971, 9 were executed, 8 died in jail, 8 received life sentences, 20 were freed after spending various periods in jail and 5 sought political asylum abroad. On the economic front thousands of PEULS, who were the main traders in the country, were jailed or executed.

previous commitments, not to mention lingering fears of repression, hampered the development of the private sector and the liquidation of inefficient public enterprises. The new regime, which came to power in 1984, did not have the same ideological hang-ups. The government engaged in a series of far reaching reforms to free the Guinean economic system from pervasive state control. The reforms towards a market oriented system included a steep adjustment of the value of the currency, the dismantlement of the system of price control, the liberalization of internal and external trade, the closing of inefficient public enterprises and a reduction in government and public sector work force. The rehabilitation of the banking system was an essential part of this program of reform.

2. Characteristics of the Guinean banking system from 1960 to 1985.

2.1 With the exception of the Islamic Bank of Guinea (BIG), which was extablished in 1983, and by the end of 1985 accounted for less than five percent of the total deposits and credits of the system, all banks in Guinea were fully owned by the government. Most of them were established with a uniform initial capital of 150 million of guinean francs or 15 million of sylis after the change over from the guinean franc to the syli on a 10 to one basis. Only the Central Bank and BCG which started operations in 1984 had a higher initial capital (GS 50 million for the Central Bank and GS 150 million for BCG). The capital of the specialized banks was never increased to reflect the growth in nominal terms of their operations, so that at the time of their closing their capital represented less than half a percent of their total assets and liablilities (Table 2). Moreover, the banks were prevented from building up reserves to improve their capital funds position as all their profits, reserves and depreciation allowances were by law transferred to the government.

TABLE 2

Guinea: Capital and Total Assets of Specialized Banks
(June 30, 1985, in millions of Sylis)

	Capital	Total Assets
CNCIH	15	36,684
BGCE	15	21,123
BNSE	15	3,626
BNDA	15	2,326
BCG	150	2,036
BNDE	15	986
	225	66,781

(Source: BCRG)

2.2 The banking system was highly specialized with each bank serving only a special category of customers or engaging only in a special type of operations. BGCE and BNSE were not allowed to accept deposits in sylis and their operations in local currency were handled by CNCIH on their behalf. BNED dealt exclusively with individuals and a few public entities and was not allowed to extend credit. Its funds were invested in the form of deposits with other banks. BGCE, BNDA and CNCIH were supposed to extend credits exclusively to public sector enterprises, while BCG, which was established only in January 1984, dealt only with the private sector. Only CNCIH had branches (40 of them in 1984, including five in Conakry) and the other banks had to rely on the branch network on CNCIH for their operations outside the capital city. Starting in 1981, currency issue was entrusted to a special

institution under the direct authority of the Head of State. The inefficiency and complication of such arrangements were compounded by an excessive partitioning of operations and a lack of communication between institutions, and within each institution between its various departments. This partitioning seems to have been intended to prevent managers from getting an overall picture of the transactions they were involved in. The lack of communications was the result of incompetence and fear and reflected the deep seated mistrust of the authorities in their citizens, including civil servants. After April 1984, limits on the activities of the specialized banks were abolished. Public and private enterprises were given the freedom of choosing their bank and all banks were allowed to extend credit to the private sector. BGCE and BNSE were formally permitted to accept deposits in local currency while other banks were allowed to accept foreign exchange deposits - Residents were allowed to open accounts in foreign exchange - Bank secrecy was restored and regulations limiting cash withdrawal from deposit accounts were repealed.

2.3 The management of the banking system was centralized, and from an organizational point of view, the specialized banks were, in practice, departments of the Central Bank which approved all credits extended by the banks. Each institution was controlled by an Executive Committee (Comite de Direction) consisting of the Governor of the Central Bank (or the Deputy Governor) and the Managing Director of that institution. Above the Executive Committee there were a High Council of Issue and Credit (Conseil Superieur de l'Emission et du Credit) and a National Council of Credit. The High Council was chaired by the Head of State and consisted of six ministers including the Govenor of the Central Bank and was responsible for the determination of monetary and credit policy. The National Council of Credit consisted of the Governor and the Deputy Governor of the Central Bank and the Managing

Directors of the specialized banks. It had authority to vet all credits in excess of one million Sylis. Since 1976 there was also a National Conference on Banking and Insurance, which included all the senior managers of the banking and insurance system and was supposed to review periodically the activities of the banking and insurance institutions, assess their performance and determine their future objectives. The National Conference met in 1976, 1979 and 1981. The role of those various agencies was marginal, however. There was no monetary and credit policy as such, and the allocation of credit was based on forecast established by each ministerial department in the context of the Five-year Development Plan. Government directives, through the governor or directly, were routinely approved by the National Council of Credit and implemented by the various banks. Despite the centralization of authority there was no coordination between the different institutions and no serious attempt seems to have been made to reconcile book entries for operations involving more than one institution.

2.4 The specialized banks were essentially an instrument to implement the Development Plan and had no say in the selection of their borrowers. They extended credit to public sector enterprises on the basis of administrative decision and according to the objectives of the Plan. Long term credit was mostly financed from external lines and the banks confined themselves to the financing of working capital needs of the public sector enterprises, which in most cases meant the financing of their recurrent losses. Credit to the private sector, which was prohibited in 1965, was allowed again to a certain extent after 1979, in the context of an attempted revival of the private sector and a special bank was established to that effect in early 1984 (BCG). Figures available, however, indicate that credit to the private sector, including credit by BIG, the Islamic Bank (technically in the form of investments), represented less than 8 percent of total credit at the end of

1984 against 3 percent in 1981. Credit by specialized banks to the private sector represented about five percent of their total portfolio at the end of 1984.

2.5 Apart from their credit, i.e., disbursing functions, the banks were assigned the task of mobilizing savings and offering an alternative to currency holdings. To that effect all salaries above GS 3,000 (the starting salary in the civil service) were paid exclusively by checks, and government stores were compelled to deposit in their bank accounts all the proceeds of sales made against payment in currency. Interest rates paid in principle on deposits with a maturity of six months or more seem to have been largely negative in real terms during the period, but the absence of official price indices precludes any serious estimate of the gap between nominal interest and inflation rates. Deposits with the specialized banks represented more than half the currency in circulation in the early eighties, but the figures should be used with caution because of the general inadequacy of the data base, the frequent and sudden fluctuations in some aggregates, and the problems of classification. For instance, the bulk of quasi-monetary liabilities did not represent time and savings deposits in the conventional sense but reflected mainly deposits of state enterprises in the form of counterpart funds or provisions against letters of credit. Deposits of the private sector seem to have represented, to a large extent, funds that the holders could not withdraw because of the lack of liquidities of the banking system.

2.6 With a staff numbering 2,400 at the end of 1984, the banking system (including BCRG and BIG) was largely overstaffed (Table 3) as was the case for the entire Government and Public Enterprises Sectors. This situation reflected the government's policy to provide employment to all school graduates, regardless of qualifications.

TABLE 3

Staff Members in the Banking Sector (end of 1984)

BCRG	400
BCG	106
BGCE	180
BNSE	108
BNDE	118
CNCIH	1,300
BNDA	100
BIG	36
Total	2,348

(Source: BCRG)

In early 1985, the management of BCRG and CNCIH, which accounted for two-thirds of employment in the banking system, reckoned that they could cut down by half the size of their staff without any problem. The only privately owned bank at the time (BIG) accounted only for one and a half percent of the total employees in the sector. The absence of data makes it impossible to relate staffing levels to the volume of activity (number of accounts and of book entries, number of deposits and withdrawals) and to measure, however roughly, the productivity of the staff. The total number of accounts was estimated to 130,000 but, in all likelihood, included a number of dormant accounts. The salary scale in the banking sector was the same as in the civil service and ranged from GS 3,000 to 20,00 per month, that is from the equivalent of US $40 to 800 on the basis of the official rate, but only to a fraction of those figures in terms of purchasing power. Bank personnel at all levels were by and large underqualified and poorly motivated. Recruitment and

promotions were heavily influenced by the perceived political reliability of the candidates and their tribal connections. There were obvious cases of nepotism and favoritism.

2.7 The working conditions in the banking system ranged from poor to dismal. Physical facilities were generally appalling. Basic maintenance of the buildings was ignored and there was a shortage of the most common supplies and equipment, including typewriters and calculators. Data processing equipment, provided under foreign assistance in 1983, was stored in the basement of one of the banks (CNCIH) and installed only in 1988. Telephone and telex communications were uniformly poor and power failures frequent.

3. Causes for the collapse of the Guinean banking system

3.1 It is not easy to determine exactly the causes for the failure of the Guinean banking system. The absence of records, the inadequacies and, in some cases, adulteration of data make it difficult to follow the building up of problems and to allocate responsibilities. Annex II shows the evolution of the consolidated balance sheet of the specialized banks from 1982 to 1985, as they have been reconstructed from IMF reports and from information provided by the Liquidation unit in the Central Bank. The consolidated balance sheet of the specialized banks at the time of their closure suggests that the inability of their borrowers (private and public sector enterprises) to repay their loans was only part of the problem as public and private sectors deposits exceeded by far the amount of the specialized banks' claims on both sectors. A significant portion of the deposits seems to have had their counterpart on the assets side in various and unrecognized claims on other banks, which brings into question the adequacy of management and internal control in the concerned institutions. Finally, the importance of the specialized banks'

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liabilities to the Central Bank, according to the latter's books and the huge discrepancy with the net position vis a vis the Central Bank as reported in the books of the specialized banks, raise serious doubts about the efficiency of BCRG's supervision of the banking system.

Insolvency of the public and private sectors enterprises

3.2 In the centrally planned economy of Guinea, banks were not expected to pass any judgment on the solvability of the borrowing state enterprises. Their role was to extend credits (short term in principle) according to the instructions of the authorities and the specification of the Development plan. At maturity, the account of the borrowing firm was automatically debited, even at the cost of increasing its debit balance. When extending credit to private sector borrowers (before 1965 and after 1979) banks did not assess seriously the quality of the borrowers on the basis of objective criteria and seem to have been mainly influenced by the authorities' suggestions, personal relations or bribes. The insolvency of most state enterprises and of many private borrowers (most of them friends of the old regime) made the specialized banks' entire portfolio practically unrecoverable. By the end of 1987, less than two percent of the banks' claims outstanding in December of 1985 had been repain (GF 181 million out of a GF 10.4 billion portfolio). The poor quality of their portfolio, however, did not bring the fall of the specialized banks, because of offsetting transfers from the government to the public enterprises. As required by law, public enterprises each year paid to the government accounts the entirety of their profit (if any) and depreciation allowances. The government, however, from time to time, transferred funds to public enterprises to strengthen their capital funds or to wipe out their losses. For instance the liquidation in 1981 of the five sectorial holding companies left a deficit of over GS 6 billion, which was settled by a

government transfer of the same amount. Altogether, the net transfer of the government, excluding tax payment, to the public sector enterprises during the 1979-82 period, averaged GS 2 billion a year. Without those transfers, the net claims of the specialized banks on the public sector enterprises would have more than doubled (from GS 6.4 to GS 14 billion) between January 1979 and December 1982 (Annex III). Instead there was a slight improvement in the net position of the public sector enterprises (from GS 6.5 to 5.9 billion during the period) as well as a significant reduction in the gross claims of the banking system on the sector.

Mismanagement and Frauds

3.3 The main responsibility for the failure of the banking system seems to fall on the management of the banks themselves, which were unable to prevent widespread irregularities, manipulations and frauds. The lack of qualified staff, the absence of any system of internal control and of reconciliation of book entries, the excessive partitioning of operations and the lack of communications between departments and institutions resulted in confused and disordered accounting practices. Items were not entered in the books or were entered with considerable delays. Financial statements were not prepared or when prepared, were often adulterated. Participation in various schemes to take advantage of the accounting chaos was widespread and seems to have involved staff members of the banking system at all levels as well as their friends and allies in the public and private sectors. In view of the disorganization of the accounting system the frauds did not require sophisticated manipulations. Fake or alterated documents, forged entries in the books seem to have been used with equal and positive results. Depositing for immediate credit a certified check drawn on another bank was a most favored means of boosting an account balance. As a result of these various

actions, the assets of the banks increasingly included claims on other banks or on the Central Bank, which were not recognized by the alleged debtors. Those fictitious assets amounted to about GF 30 billion at the end of 1984 and included a difference of GF 12 billion in the net claims of the Central Bank on the specialized banks, as respectively reported in their books, a GF 5 billion discrepancy between the reciprocal claims between specialized banks and a gap of GF 13 billion in the interbranch account (compte de liaison) of CNCIH. By the time of their closure on December 22, 1985 the fictitious assets of the state banks had jumped to about GF 40 billion including GF 4.5 billion in certified checks issued after July 26, 1985 when the practice was prohibited.

Supervision of the Banking System

3.4 It is difficult to understand the role that the Central Bank played in the failing of the banking system. The organization of the system gave the Central Bank a decisive say in the working of the state banks. It's governor, who enjoyed ministerial rank in the cabinet, was the chairman of the Executive Committee of each bank. An Inspection Department in the Central Bank was responsible for the supervision of the banking system and its inspectors were supposed to make and indeed did make on-site inspections. Nothing much, however, seems to have come out of these inspections except in some cases the conviction of bank officials or staff who were no longer in political favor. On the whole it seems that the Central Bank turned a blind eye on highly questionable practices either on self interest grounds or in order not to upset the delicate balance of political power within the system. The Central Bank apparently chose to ignore the blatant and growing discrepancy in the amount of its claims on state banks according to its books and the banks' books. Also its decision in 1981 to end all clearing house operations suggest

that conflicting interbank claims were already getting out of hand by that time. The Central Bank for reasons ranging from an underestimate of the crisis to the fear of losing face or worse was unable to tackle the problem and resorted to various expediencies to help the banking system survive. Efforts to increase the resources of the banks and prevent loss of cash included the mandatory payment by checks of all salaries in excess of GS 3,000 a month and GS 20,000 ceiling on monthly cash withdrawals from a bank account. Exchanges of currency notes seem also to have been a favorite device to reduce the share of currency in the money supply (and also to detect hoarding and other anti-socialist behavior). In the last currency exchange under the old regime in April 1981, exchange for new notes was limited to a maximum of GS 20,000 with any amount in excess deposited with the banking system. A few months later in August 1981 and June 1982 respectively, the GS 500 and 100 notes were withdrawn from circulation and their amount credited to bank accounts.[2] The exchange operations seem to have been costly, as the amount of new notes put in circulation exceeded significantly the amount of notes presented for exchange especially in April 1981 when the exchange operation was entrusted to the party organization.[3] The importance of the leakage might have eased somewhat the hardship of depositing part of the notes with the banking system and possibly increased the amounts credited to bank accounts. As mentioned earlier, the authorities also helped the banking system, through infusion of cash, reduce the indebtedness of the public enterprises (Annex III). Even if the taxes paid by the public sector enterprises are taken into consideration, the net transfers of the government to those enterprises

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2 About one year later a shortage of currency notes forced the authorities to reissue those notes.

3 The January 1986 currency exchange was no exception. Issuance of new notes totalled GF 24.3 billion while the amount of old notes presented for exchange did not exceed GF 21.3 billion. The overall loss was subsequently reduced from GF 3 billion to GF 2.2 billion as notes which had been diverted by local authorities for GF 800 million were reimbursed by the government.

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amounted to GS 2.8 billion in 1982. There seems to have been, however, a growing feeling in government circles that all those measures were more a palliative than a cure and that the timid reorientation of the economy toward a more market oriented system as well as the closing of a number of inefficient public enterprises were not sufficient. In the last year of his life President Sekou Toure had requested and obtained from France the secondment of a senior financial advisor and negociations were underway with IMF about technical assistance in the banking field.

4. Closing and Liquidation of the Specialized Banks

4.1 The new regime inherited a disastrous situation. If anything, the change over to a new government tended to make matters worse in the banking system. The possibilities for the banks to engage in operations previously prohibited because of their specialization, the liberalization of internal and external trade, the return of a number of refugees increased the opportunities for profitable manipulations and frauds while the subsiding fear of harsh repression made many operators bolder. The fictitious assets in the accounts of the specialized banks increased significantly in 1984 and in 1985. The use of certified checks to inflate deposit balances spread out of control. The prohibition of the practice in July 1985 was to no avail and certified checks issued after July 1985 represented close to one third of the private sector deposit on December 22, 1985.

4.2 Although the rehabilitation of the banking system was high on the agenda of reform of the new government, things moved slowly at first. A draft banking legislation discussed first with IMF in October 1984, was enacted in March 1985. Among other things it opened the possibility for non Guineans to manage a bank, subject to prior approval by the authorities, but included no

provision regarding bank supervision and prudential ratios. A new Central Bank legislation was enacted in September 1985, which transferred to the Central Bank the privilege of currency issue. The first technical assistance experts, including a general Advisor who was shortly afterwards appointed Deputy governor of the Central Bank, reported for duty in the Spring of 1985. A technical assistance mission of the IMF visited Conakry in March 1985, to report on the situation of the banking system and offer suggestions for its rehabilitation. A consulting firm, financed by the World Bank, was hired to assist the government in restructuring the banking system, and several consultants visited Conakry to that effect in October and November 1985. Early in 1985, the government had engaged negotiations with several French banks to establish new banks in Guinea under foreign management. The first bank (Banque Internationale pour l'Afrique eu Guinee - BIAG) started operations in August 1985, with a 51 percent participation of the government in the capital. The second bank (Societe generale de Banque eu Guinee - SGBG) opened its doors in December 1985 as a privately owned institution, with 55 percent of the capital subscribed by private Guinean investors. The third bank (Banque Internationale pour l'Industrie et le commerce eu Guinee - BICI-GUI) started operations in January 1986 with an initial 51 percent participation of the government.

4.3 The consensus which emerged at an early stage of the discussions with the new Guinean authorities was that most of the state banks should be closed and liquidated as they were beyond salvation. The government, as well as some of its advisers at the Central Bank, however, pleaded in favor of the rehabilitation of the CNCIH, as they felt that it was essential to maintain at least one commercial bank in the country, especially one with branches outside Conakry, to meet the needs of the Treasury. This position did not take into account the fact that CNCIH was even in a worse shape than the other state

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banks[4] (The interbranch account of CNCIH alone represented about one-third of the fictitious assets of the whole banking system). The operations of CNCIH on behalf of the Treasury outside Conakry involved mainly the payment of the salaries of the public sector employees, and it was possible to transfer those functions to the provincial authorities as long as the Ministry of Finances and the Central Bank, with the half of the money, were able to ship the needed cash to the provinces. The authorities, however, gave up any hope to save CNCIH when the prospective foreign banks, which were prepared to set up affiliates in Guinea, refused adamantly to take over any of the existing banks, even if their assets and liabilities were clearly segregated and guaranteed by the government. The state banks had nothing to offer, even in terms of physical facilities, but the negative attitudes of the new banks reflected essentially their desire to follow their own personal policy and staff selection and to start operations without the burden of the plethoric and underqualified staff of the existing institutions. Other arguments against the closing of all banks, such as the interest of the depositors and the needs of the businessmen, were easily dismissed as most of deposit balances were frozen anyway and businessmen could, since August 1985, rely on a newly established foreign bank (and since December 1985 on a second one).

4.4 On December 22, 1985 the President of the Republic announced the immediate closing of all the state banks and their liquidation under the supervision of the Central Bank. The Islamic Bank (BIG) which was almost in as difficult a situation as the state banks, was left to its own devices, as it was privately owned and in any case, of marginal importance. The Central

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4 The IMF technical assistance report in March 1985 states, "In our view the present state of the existing public banking institutions is such that attempts to work within the existing system will not be successful. We have considered at some length the possibility of attempting to rehabilitate CN, as had been suggested in Washington, but have concluded that this option is not feasible. CN, in fact, has experienced all of the problems of the other banks but to a much greater extent."

Bank was reorganized and started its operations in 1986 on the basis of a start up balance sheet including only items the existence of which had been verified and confirmed.

4.5 The liquidation of the specialized banks was entrusted to a Liquidation Committee consisting of three members representing, respectively, the Central Bank, the Planning Ministry, and the Ministry for Economy and Finance under the general supervision of the Central Bank. The first task of the committee was, with the assistance of a foreign consulting firm, to identify the net claims of the banking system on public and private borrowers and the "true" deposits of the public with the banking system, to "clean up" the interbank accounts including those involving BCRG and the interbranch accounts of CNCIH, and finally to make an estimate of the fixed assets of the banks. This was not an easy task. Many documents were missing while some documents, particularly those which appeared at a later date, were of dubious validity. Decisions on the validity of claims were unavoidably subjective and arbitrary in many instances. Principles and guidelines established beforehand were not always strictly adhered to. A special Liquidation Unit was set up in the Central Bank under the direct authority of the General Controller of the Bank to implement the decisions of the committee and keep the accounts of the liquidation operations. With the passage of time the Governor of the Central Bank and the Liquidation Unit took over gradually the responsibilities of the Committee which met for the last time in 1987. The staff of the closed banks were placed in "situation de disponibilite" which meant that they were available for transfer to other parts of the civil service or for hiring by the private sector. In the meantime, they continued to be paid by the government and became part of the more general problem of redundancies in the public sector. Some of them were rehired by the new banks.

4.6 The initial and most important task of the liquidation Committee was to verify depositors' claims on the banks. The operation involved, 1) the adjustment of the deposit balances after cancellations of all "certified" checks drawn after July 26 1985 and credited to the account of a depositor, and 2) the verification of depositors' claims which had not been entered or had been entered inaccurately in the books of the banks. The first operation, the reduction of balances (the so called "refaction") was completed within a few months in 1986, but complaints are still heard, in a number of cases, the cancelled checks were debited to the wrong accounts). The verification of the claims held by depositors is still going on and regularly increases the amount of deposits to be reimbursed. The failure of the authorities to set up a deadline for the registration of claims on banks by alleged depositors, and also for their disposition, was a major flaw. It cost the government and is still costing it hundreds of million of Guinean francs. The second flaw in the adjustment and verification modalities was to exclude the public sector enterprises from the operation of "refaction", on the grounds that all public enterprises' claims on banks were to be cancelled outright with the government allocating funds on a selective and direct basis to the enterprises which were continuing their operations. In fact, there were so many exceptions to that general rule that, in 1986, reimbursement of public sector deposits exceeded reimbursement to the private sector. For the entire period through September 1987, repayments to the public sector represented 41.7 percent of their claims, recorded as of December 22, 1985. Repayment to the private sector represented the same percentage (41.8 percent) of the claims on that sector at the same date (before "refaction").

4.7 At the time of their closing, the cumulative losses of the state banks were roughly equivalent to the total of the depositors and BCRG's claims on those banks. There was hardly anything of value on the assets side, except

for the balances in correspondants accounts. Banks did not have any fixed assets (land and buildings belonged to the state). The sale of their equipment and supplies yielded less than GF 6 million (equivalent to less than $20,000 at the 1986 exchange rate) and the rate of recovery on their loan portfolio was still below 3 percent almost three years after the closing of the banks. At the end of July 1988, after reimbursment to correspondants, sales of assets amounted to about GF 1.8 billion including

cash in vault	0.1
correspondants (net)	1.4
loans repayments	0.3
Total	1.8

Annex IV shows the evolution of the total claims (excluding correspondants) between December 1985 and September 1987 as expressed in Guinean francs and an estimate of their value in US dollars. The progression of the total amount of the claims (in GF) is the result of the adjustment of the claims expressed in foreign exchange to reflect the depreciation of the Guinean franc, and the acceptance of claims which were not included in the consolidated balance sheet on December 22, 1985. Those claims (including reimbursements) represented about 7 percent of the estimated 1987 GDP at market prices.

4.8 Deposit balances as verified by the Liquidation Committee were supposed to be reimbursed as follows:

(a) balances in individual accounts not exceeding GF 500,000 were reimbursed in full.

(b) balances in individual accounts exceeding GF 500,000 could be used to pay for the purchase of agricultural inputs and equipment (when available) from public sector enterprises or to pay

customs duties.

(c) the net claims of the public sector enterprises were cancelled as it had been decided that the government would allocate to those enterprises still in operation such amounts of funds as needed for their activities.

In practice, however, the option given the account holders to pay for agricultural inputs and equipment was discontinued in 1987, because of the widespread use of fictitious invoices. The rule providing for the cancellation of all public sector enterprises received only limited applications. Balances in excess of GF 500,000 were also reimbursed in special cases to relieve "depositors' hardships." It is also difficult to understand why significant amounts representing balances of less than GF 500,000 were still repaid in 1987 and 1988, since those claims should have been settled by priority in 1986.

4.9 Total reimbursments amounted to GF 12.0 billion by the end of 1987 and, according to the liquidation unit, remaining claims to be reimbursed totalled GF 9.9 billion on that same date. Repayments in the first seven months of 1988 amounted to GF 1.5 billion (Annex V) but claims outstanding at the end of 1987 had not been reduced by the same amount as there had been further adjustments of claims denominated in foreign exchanges on account of the depreciation of the local currency since January 1st, 1988 and new claims had been verified and registered since then. Balances between GF 500,000 and 1,000,000 are now being reimbursed. Earlier this year the Central Bank and the Ministry of Finance agreed to settle all the remaining valid claims through the issuance of interest bearing Treasury bonds. Discussions on the modalities of such an operation seem to have died down and it is clear that the proposal did not elicit much enthusiasm in either agency. The Ministry of

Finance did not see much point in paying an interest on the bonds which would be issued instead or reimbursing gradually the claims through an increase in the non-interest bearing Central Bank advances to the government. The Central Bank's argument that the reimbursment of the bonds would add to inflationist pressure is valid only to the extent that the pace of the bond repayment would exceed the expected disbursement of funds according to the present modalities of settlement of the claims.

4.10 The settlement of the deposit claims on the state banks was financed initially by a GF 4.5 billion government allocation which resulted in an equivalent increase in the Central Bank advances to the government. The realization of the state banks assets provided 1.8 billion after netting the reciprocal claims between the banks and their correspondants. Claims repayments in excess of the initial allocation from the government and the proceeds of assets realization have been financed by direct advance from the Central Bank (Annex V).

4.11 The liquidation of the state banks has been, so far, a costly operation, which was financed essentially by money creation and increased inflationary pressure. Reimbursments to the private sector and the public sector enterprises, at the end of July 1988, were roughly equivalent to 15 percent of the money supply on that date. The total cost of the liquidation of the state banks will exceed 40 billions of Guinean francs, which will be charged to the government (Table 4).

TABLE 4

Cost of the Liquidation of the State Banks

(in Billions of Guinean Francs)

BCRG Claims	20.6
Net Reimbursments before July 1988	10.6
Remaining Claims to be Reimbursed (est.)	10.0
Total	41.2

To this cost, it should be necessary to add various miscellaneous expenses, including the amounts paid to the consulting firms which assisted the authorities in verifying claims and sorting out the accounting mess (between three and four millions of US dollars), the cost of the liquidation which was not charged to the banks being liquidated and was born by the Central Bank and the cost of the salaries of the banks' staff for an interim period. If everything is taken into account, the total cost of the liquidation may well reach 45 billions of Guinean francs or close to 100 million of US dollars at the present exchange rate.

5. The New Guinean Banking System

5.1 The establishment of new banks in Guinea was part of a vast economic and monetary reform program which included a currency change over from the syli to the Guinean franc, a 12-fold evaluation of the local currency, the liberalization of imports and agricultural exports, the gradual abolition of price control and the establishment of a foreign exchange auction market. A new commercial bank (BIAG) started operations in August 1985 before the closing of the specialized banks. Two other commercial banks (SGBG and BICIGUI) followed in December 1985 and January 1986, respectively. The only

privately owned banks in existence in Guinea prior to 1985 (BIG) continued operations but required significant infusion of new capital funds to offset accumulated but yet unrecognized losses. At the end of 1986 the total assets and liabilities of BIG represented 17 percent of the total assets and liabilities but since then has declined to 9 percent in June 1988. Moreover, BIG balance sheet was inflated by the importance of its non-performing investments which amounted to over two thirds of its total portfolio. The bank however insisted that it was still expecting to recover up to 75 percent of those non-performing investments. For the first time at the end of 1987, BIG allocated a substantial portion of its profits to provisions against bad loans.

The New Banking Dystem as a Joint Venture Between the Government and Foreign Banks.

5.2 The three new commercial banks were established with foreign participation in their capital and under foreign management. The Guinean Government took an initial 51 percent participation in the capital of BIAG and BICIGUI. The balance of the capital is held by the Banque Internationale pour l'Afrique de l'Ouest (BIAO) and by the Societe Internationale pour le Financement et le Developpement en Afrique (SIFDA) for BIAG and by the Banque Nationale de Paris (BNP), three international or national financial assistance agencies (including IFC), the European Investment Bank and the Societe Financiere pour les Pays d'Outremer for BICIGUI. The government participation in BICIGUI has been reduced to 39.5 percent as a result of a capital increase but the government retains the option to regain its previous majority control through subscription to a special capital increase. The shares of the third bank (SGBG) are divided between the Societe Generale of France (45 percent)

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and private Guinean investors (55 percent). The three banks are managed by a French bank (BIAO, BNP and SG, respectively). Expatriates represent about seven percent of their total staff (Table 5).

TABLE 5

Staff of the Guinean Banks (January 1988)

	Total Staff	Expatriates
BIAG	84	7
BICIGUI	268	18
SGBG	130	8
BIG	50	5
Total	532	38

(Source: Commercial banks)

The banks are adequately capitalized. Capital funds of the commercial banks amounted to GF 8.6 billion at the end of June 1988 and were equivalent to about 9 percent of the total assets and liabilities of the banking system (Table 6).

TABLE 6

Ratio of Capital Funds in the Banking System (end of period)

Capital Funds as a Percentage	Dec. '86	Dec. '87	June '88
Total Assets	13.3	11.1	9.6
Deposits	21.4	19.3	15.6
Credits	43.0	27.9	22.6

(Source: Commercial banks)

5.3 The Guinean authorities had no other choice but to turn to foreign banks to revive the banking system. The old state banks were in such a state of disrepute that the public would not have trusted any local institution which could be associated, however remotely, with those banks. Qualified managers were not available locally while foreign banks (French banks in this case) were thought to have sufficient human resources and experience in the area to be able to assemble rapidly a management team for a Guinean subsidiary. Foreign banks also could provide capital which was hardly available locally at the time although SGBG was able to attract private investors (most of whom had just returned from abroad). The government participation in the capital of two of the new banks reflected the perceived scarcity of local capital as much as it represented a concession to the nostalgic partisans of state ownership of "sensitive" enterprises. The government so far seems to have made no attempt to use its participation to influence banks' business decisions but BIAG and BICIGUI have been claiming lately that they should have a monopoly in managing the funds of the public sector enterprises because of the government's participation in their capital. It might probably have been better to provide from the start for a rapid disengagement of the state and a sale of its bank shares to local interests at the first opportunity.

5.4 In view of the conditions prevailing in Guinea, foreign banks were somewhat reluctant to answer the invitation of the authorities to set up business in Guinea. Various incentives were included in the specific agreement which each bank concluded with the government prior to its installation. A similar agreement had been concluded prior to 1984 between the government and BIG. New banks were granted extensive tax holidays for periods of 3 to 15 years, applicable to the institiution, its shareholders and expatriate staff, and the right to hold their capital in foreign exchange abroad. Some provisions were specific to one institution. A bank was given

the option to keep its account in foreign exchange. Another was guaranteed by the government 20 percent of all foreign trade operations and given the right to deduct from its taxable profits after the end of the period of tax holidays the amount of the depreciation allowances made during that period. In one case a bank was exempted in advance of any penalty it could incur for non-compliance with reserve requirements. Annex V gives a summary of the main provisions included in the agreement. While some of the provisions may have implicitly been permitted to lapse, the advantages extracted by the banks are now a source of resentment for the authorities and gradually for the public opinion. Critics of course tend to be forgetful of the difficult conditions under which the new banks started operations in 1985. At the same time some of the provisions of the agreement border on the petty and are not worth the ill will they have generated. A provision such as the holding of capital in foreign exchange abroad might have been justified at some stage because of the massive overvaluation of the local currency but is less defensible once the fixed investments financed with a portion of the capital have been completed and the value of the currency has more or less stabilized. In any case the authorities should have insisted that the capital be deposited in a foreign exchange account with the Central Bank.

Favorable Business Conditions for Banks in Guinea

5.5 Despite the widespread mistrust in the banking system, the appalling physical facilities, the absence of communications with the external world and the poor qualifications and motivation of the local staff, business conditions for the new banks in Guinea were good from the start on some important grounds. First, the banks were free of any government interference in their operations. There was no attempt by the authorities to direct credit towards "privileged" borrowers or the government. The banks recruitment policies were

free of any government intervention and in practice there was no limit on the hiring of expatriates (there was only a 15 percent ceiling in the government agreements with BICIGUI and SGBG). Banks were allowed to import free of custom duties equipment and supplies needed for their operations and the housing of their staff. Credit control and supervision by the Central Bank were minimal, Banks were not subject to reserve requirements or to prudential ratios. Interest rates charged on loans or paid on deposits were not regulated until September 86 and January 87 respectively - Maximum lending rate were increased significantly in January 1987 and February 1988 (although they remained negative in real terms) but enforcement of those rates did not seem to rank high in the priority list of the Central Bank. Interest rates remain free on demand deposits and time deposits with a maturity of less than 6 months. The spread between minimum deposit rates and maximum lending rates was comfortable (from 8 percentage points for time deposits with 6 to 12 month maturity to 13 percentage points for savings deposits) and the modalities of computation of interest rates on time and savings deposits tended to reduce the effective rate paid on those deposits. Commissions were free until February 1988. Banks were allowed to open accounts in foreign exchange for non-residents and residents alike, subject for the residents to some conditions which were initially very liberal in nature. Banks were also permitted to invest their liquidities abroad with their correspondants even for the portion of those liquidities which exceeded their foreign exchange risk exposure, which means they were permitted to speculate against the Guinean franc at a time when the depreciation of the local currency was a sure bet.

5.6 The main advantages the new banks enjoyed, however, was related to the negligible cost of their deposits. For all practical purposes currency holdings and bank deposits were (and still are) the only financial assets in

Guinea. The government has issued no securities and shareholding in a few private or mixed sector companies including the banks themselves is minimal. For a while after the closing of the state banks in 1985 financial assets consisted almost exclusively of currency. At the end of January 1986 deposits in Guinean francs with the commerical banks amounted to GF 1.6 billion and represented only six percent of the total money supply. The liberalization of internal and external trade, the opening of a foreign exchange auction market and in general the return of some normalcy in business transactions required the build up of deposit balances. The growth of deposits since 1986 indeed has been impressive and exceeded expectation. Deposits account now for over 25 percent of the total money supply but comparison with other countries in the area suggest that there is still ample room for further improvements in the ratio of depositor's money supply. Banks felt that the deposit market was to a large extent a captive market and there was no need for a remuneration of those deposits. Their rapidly expanding deposit base also enabled banks to neglect their relative share of the market and weakened their competitive spirit. As a result the average remuneration of deposit ranged from 0.3 to 1.0 percent in 1987 depending on the bank. Initially deposits were mainly in foreign exchange and it is only since February 1987 that deposit balances in Guinean francs have exceeded deposit balance in foreign exchange. Annex VII provides some indication as to the evolution of the deposit and credits of the banking system since the end of 1986.[5]

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5 Figures for foreign exchange deposits and public sector time deposits are inflated as a result of a US $ 12.5 million government deposit with BIAG as a garantee of a transaction concerning the mining sector. In effect, the deposit is with BIAG Paris and should not appear in the books of BIAG.

Profitability of the Banking System

5.7 The profit and loss statements of the commercial banks for 1987 (Annex VII) illustrates the profitability of the banking system as a consequence of the good business conditions described above. Total operating income for the entire system represented over 18 percent of the average banking assets (16.5 percent of average total assets). Net operating income amounted to over 7 percent of average banking assets (6.7 percent of average total assets) and close to 50 percent of the capital funds (Annex IX). The large spread between the average cost of deposit (0.6 percent) and the average interest rate charged on loans (19.4 percent) and the size of the various commissions charged by the banks (7.5 percent of average total assets) explains those favorable results despite considerable overheads linked to the initial starting cost of business and the cost of expatriate staff. Overheads represented 8.6 percent of average total assets in 1987. Furthermore the net profits of the banking system before depreciation and provisions may have been somewhat understated, for instance because of the automatic reevaluation of the capital (partially offset in some cases by a parallel revaluation of fixed assets), the undervaluation of some assets (participation in a specific case) and the overvaluation of services rendered by the head office.

5.8 Profits margins of the banking system might appear excessive on many accounts but were necessary to enable the banks to finance their initial cost and (for BICIGUI and to a lesser extent SGBG) the development of their branch network. Depreciation allowances amounted to over GF 650 million and represented close to 15 percent of the fixed assets and participations of the banking system at years end. There were also necessary to pay for the high

personnel expenses of the banks which were equivalent in 1987 to 3.7 percent of the average total assets ranging from 2.1 percent for BIG to 4.5 percent for BICIGUI (Table 7).

TABLE 7

Cost of Staff in the Banking System in 1987

	BIG	BIAG	BICIGUI	SGBG	TOTAL
As a Percentage of					
Average Deposits	7.6	3.8	7.2	7.6	6.3
Average Credits	4.2	14.6	12.4	9.2	10.2
Average Total Assets	2.1	3.0	4.5	4.0	3.7
Total Overheads	45.0	31.1	46.7	48.0	43.0
Per Staff Member					
(GF million)	2.9	4.3	3.4	4.5	3.8

Source: Commercial Banks

The average cost per staff member is based on the total number of staff members in January 1988 and is understated as the average number of staff during 1987 was less that the number at the end of the year for all banks with the exception of BIG. Expatriate staff account for about 7 percent of the total number of staff and for over 50 percent of the total cost of the staff. Finally comfortable profit margins were also indispensable at least during an initial period to enable its banks to build up adequate provisions against doubtful loans. Provisions for the 1987 financial year amounted to GF 2.9 billion and represented over 10 percent of the total credit outstanding at the end of the year and 13.7 percent of the average credit during the year (Table 8).

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TABLE 8

1987 Provisions Against Bad Loans

	BIG	BIAG	BICIGUI	SGBG	TOTAL
As a Percentage of					
Credit at Year End	2.7	7.7	18.7	5.6	10.0
Average Credit	3.6	10.9	23.3	8.4	13.7
Average Assets	1.8	2.3	6.9	3.6	5.0

Source: Commercial Banks

5.9 The poor quality of the banks' portfolio, as suggested by the importance of the provisions, may be linked to the recent establishment of the banks, their insufficient knowledge of credit conditions in Guinea, the absence of previous credit records of their borrowers and in some instances to inadequate portfolio managements. It may also be related to difficulties in securing loans with proper collateral and to foreclosure procedures. The problem is compounded by the absence of warehouse facilities and inadequate insurance protection. Not withstanding those explanations, the poor performance of the banking system with regard to the quality of its loan portfolio is a cause for worry, especially since the banks have been operating with a larger expatriate staff than in many countries in the area and have been immune from any government pressure in their loan policy. BIAG and BICIGUI reject vehemently any suggestion that their provision policy might have been influenced by a desire to hide excessive profits and in the case of BICIGUI to show clearly the cost associated to the setting up of their branch network. The case of SGBG is different as pressure by local shareholders might have resulted in lower provisions than called for by the portfolio situation. The provisions as proposed by SGBG in an initial version of its profit and loss statement for

1987 (as certified by the auditors) were halved in a second version possibly to increase net profit significantly and justify the payment of a comfortable dividend. All banks now insist that the quality of their portfolio is a serious problem and that they have taken steps to correct the situations through a review of their loan procedure and a tightening of internal controls. They also seem anxious to pursue this buildup of their provisions to clean up their portfolio. The preliminary profit and loss statements for SGBG for the first six months of 1988 shows provisions for the semester almost equivalent to the provisions for the entire previous year (Annex X) and BICIGUI has announced a similar policy. The problem is probably less severe for BIAG. The Central Bank could also help in defining prudential rules for banks and providing guidelines for the accounting treatment of non-performing loans.

The Future of the Banking System

5.10 The determination of the banks to clean up their portfolio as soon as possible comes at the right time as their profit position may gradually deteriorate in the future. The honeymoon period with the authorities is clearly over and banks may soon have to give up some of the advantages their agreement with the authorities provided them with. The regulation holiday also is over. Banks have already been compelled, since February 1988, to reduce their commissions. For the first semester of the year, BICIGUI and SGBG reported sharply lower commissions relative to their assets on an annual basis (Annex X). Prudential ratios as well as reserve requirements may be established in a not too distant future while the authorities may be expected to urge the banks to promote more actively savings and improve remuneration of

certain types of deposits (i.e. savings deposits). Already the cost of deposits has doubled in the first half of the year and is likely to double again in the second semester to 4 percent.

5.11 The increased competition among banks as a result of the slowing down of the growth rate of deposit and the establishment of a new bank at the end of this year is bound to put additional pressure on bank margins. A more thorough screening of borrowers and the search for safer credit opportunities are bound to stimulate competition to attract the best rated clients. The spread between the average cost of deposits and the average charge on credit might come down by at least two percentage points in 1989 from 18.5 to 16. This combined with lower commissions might reduce the gross operating income of the banking systems from 16.5 percent of total assets in 1987 to 15.0 percent in 1988 and 14.0 percent in 1989. At the same time additional interest paid to depositors may add one percentage point (in relation to total assets) to the cost of funds in 1988 and another percentage point in 1989. Should the overheads remain at the same level relatively the net operating income would be cut by two thirds in 1989 and would represent only 2 percent of the total assets. This would be insufficient to provide for reasonable depreciation allowances and provisions and leave adequate net profits. Accordingly, the future health of the banking system seems to hinge on the ability of the banks to reduce their overheads. Medium term prospects in that respect are mixed. Initial costs associated with the establishment of new banks should decrease somewhat and the gradual replacement of some expatriates by local staff should generate savings which might be offset, however, by improvements in the remuneration of the local staff (their remuneration went up by 80 percent earlier this year). In the final analysis, it seems that the future profitability of the banking system will depend on the capacity of the banks to keep the growth rate of their overheads below the rate of expansion

of their deposits (or assets) basis. Preliminary results for the first semester of 1988 (for BICIGUI and SGBG) suggest that that objective is not out of reach (Annex VIX) provided the authorities adopt a cautious approach to the granting of new banking licences in order to give the existing banks time to digest the impact of the forthcoming establishment of an additional competitor.

Annex I

GUINEA: Chronology of Events Interesting to the Guinean Banking System from 1960 to 1986

September 28, 1958. Referendum on the French Community - Guinea votes No.
October 2, 1958. Proclamation of the Republic of Guinea.

February 27, 1960. Establishment of the Bank of the Republic of Guinea with the combined powers of a central bank, a commercial bank, and an exchange control office.
March 1, 1960. Issuance of a new currency, the Guinean franc to replace the CFA franc.
August 11, 1960. Nationalization of all commercial banks.
March 1961. The Bank of the Republic of Guinea is divided into four institutions: (i) a central bank, the Banque Centrale de la Republique de Guinee (BCRG), (ii) an agricultural bank, the Banque Nationale de Developpement Agricole (BNDA), (iii) a bank for foreign trade, the Banque Guineenne du Commerce Exterieur (BGCE), and (iv) a bank to finance industry, domestic trade and housing, the Credit National pour le Commerce, L'Industrie et l'Habitat (CNCIH).
March 1963. Exchange of currency.
October 1972. Exchange of currency: the Syli replaces the Guinean franc on a 1 to 10 basis.
February 1975. Trade becomes a government monopoly and all private trading (including village markets) is prohibited.
June 1977. Responsibility for non-commercial foreign transactions is transferred from BGCE to a new institution, the Banque Nationale des Services Exterieurs (BNSE).
February 1979. Merger of the Post Office Savings Bank and the Post Office Checking System into a new institution, the Banque Nationale de Depots et d'Epargne (BNDE).
January 1981. Transfer of responsibility for the issuance of currency from BCRG to a new institution, the Institut National d'Emission, under the direct authority of the Head of State.
April 1981. Exchange of Currency.
October 1981. Abolition of the Five Sector Holding Companies which controlled all the public sector enterprises.
August 1983. Establishment of a privately owned bank, operating in accordance with the principles of the Islamic Law, the Banque Islamique de Guinee (BIG).
January 1984. Establishment of a bank to finance the activities of the private sector, the Banque Commerciale de Guinee (BCG).
April 3, 1984. Change of government and regime.

March 6, 1985. New banking law.
July 26, 1985. Use of certified checks to credit bank accounts is prohibited.
September 28, 1985. New central banking law. BCRG recovers responsibility for the issuance of currency. De facto liquidation of INE.
October 7, 1985. Establishment of a secondary foreign exchange market exclusively for sales to the banking system of the foreign exchange proceeds from the following transactions: capital inflows, non-mining exports, grants, tourism. Rate FF 1 = GS 36 (equivalent at the time to US $1 = GS 290).
December 22, 1985. Closing and liquidation of the six state-owned specialized banks. The Islamic Bank (BIG) continues operations.
January 1986. Exchange of currency at par: The Guinean franc replaces the Guinean Syli.
August 1985 - January 1986. Establishment of three new commercial banks, the Banque Internationale pour l'Afrique en Guinee (BIAG in August 1985, the Societe Generale de Banque en Guinee (SGBG in December 1985, and the Banque Internationale pour l'Industrie en Guinee (BICIGUI) in January 1986, with the participation of foreign shareholders and under foreign management.
January 28, 1986. Determination of the foreign exchange rate on the secondary market on the basis of weekly auction. Rate at first auction US $1 = GF 355.
June 1, 1986. Merger of the official foreign exchange rate and the auction rate. Only one foreign exchange rate remains as determined through weekly auctions.

GUINEA: Consolidated Balance Sheet of the Specialized Banks
(in billions of Guinean francs)

Assets	31-12-82	31-12-84	30-09-85	22-12-85 (A)	22-12-85 (B)	22-12-85 (C)
Cash	0.1	0.1	0.1	0.1	0.1	0.1
Correspondents	0.9	na	0.5	0.2	0.2	2.5
Public Sector Claims	10.5	7.5	8.8	8.9	8.9	9.3
Private Sector Claims	0.4	0.4	1.8	1.5	1.5	1.5
Other Assets	1.4	0.0	0.1	0.1	0.1	0.1
Fictitious Assets	7.6	18.1	16.2	39.4	34.9	42.4
Claims on Specialized Banks (net)	(na)	(4.7)	(6.9)	(na)	(na)	na
Interbranch Accounts	(na)	(13.4)	(3.3)	(na)	(na)	na
ACRG	-	-	-	(15.0)	(15.0)	(15.0)
Assets = Liabilities	20.9	26.1	27.5	50.2	45.7	56.0
Liabilities						
Correspondents	1.5	na	1.1	0.9	0.9	3.5
Public Sector Deposits	7.1	7.1	9.8	11.5	11.5	
Private Sector Deposits	4.0	6.0	8.3	14.8	10.3	31.9
BCRG	8.0	4.4	5.4	20.6	20.6	20.6
Other Liabilities	0.3	8.6	2.9	2.4	2.4	-

Sources: IMF SM 83-167 (Balance Sheet 31-12-82) and Technical Assistance Report of March 11, 1986 (Balance Sheet 31-12-84); Development Finance Consultants' Report of Dec. 26, 1985 (Balance Sheet 30-09-85); Liquidation Unit at BCRG on basis of Development Finance Consultants' Reports (Balance Sheet 22-12-85, A, B, and C)

Explanatory Note on Annex II

1. In the December 31, 1982, December 31, 1984 and September 30, 1985 balance sheets the position of the Specialized Banks vis a vis BCRG is net and appears only on the liabilities side. It differs significantly (by about GF 12 billion at the end of 1984) from the net position as reflected in the BCRG's books.

2. In the three versions of the December 22, 1985 the figure for the liabilities of the specialized banks to the Central Bank is derived from the latter's books. The amount of GF 20.6 billions which represent the net claims of the Central Bank on the Specialized Banks according to BCRG exceeds by GF 15 billion the net liabilities of the Specialized Banks to the Central banks as reflected in their books. This difference is included in the fictitious assets of the specialized banks on the other side of the balance sheet. It accounts for more than half of the big jump in the total balance sheet from 1984 to 1985.

3. In the B version of the December 22, 1985 balance sheet, the deposits of the private sector have been adjusted to reflect the cancellation of the certified checks drawn after July 26, 1985 and credited to private sector accounts (an operation prohibited since July 26, 1985). The C version is derived from the B version but some of the assets and liabilities in foreign exchange have been adjusted to reflect the new exchange rate established on October 7, 1985 for certain transactions (FF 1 = GS 36 instead of SDR 1 = GS 24.68 approximately a 30 percent devaluation).

GUINEA: Specialized Banks' Claims on Public Enterprises and Financial Flows Between the Government and those Public Enterprises, Excluding Tax Payments
(end of period in billions of Guinean francs)

	1978	1979	1980	1981	1982
1. Claims on Public Enterprises	11.4	5.9	14.6	15.5	10.5
2. Deposits of Public Enterprises	5.3	4.3	6.9	7.1	4.6
3. Net Claims	6.1	1.6	7.7	8.4	5.9
4. Profits and Depreciation Allowances Paid to the Government		3.3	1.6	4.0	5.4
5. Transfers from Government		7.9	-	3.0	11.5
6. Net Transfers from Government					
7. During the Year		4.6	-1.6	-1.0	6.1
8. Cumulative since Jan. 1, 1979		4.6	3.0	2.0	8.1
9. Net Claims on Public Enterprises if there had been no Transfer from Government (3+8)		6.2	10.7	10.6	14.0

Source: Data provided by Guinean Authorities as reported in IMF SM/83/167.

Annex IV

Claims of the BCRG and Depositors on State Banks
(in billions of Guinean francs)

	December 22, 1985			Sept. 30, 1987
	A[1]	B[2]	C[3]	
1. BCRG claims on State Banks	20.6	20.6	20.6	20.6
2. Deposits	26.3	21.8	31.9	26.9
Private Sector	11.8	10.3	na	11.6
Public Sector	11.5	11.5	na	15.3
3. Total (1+2)	46.9	42.4	52.5	47.5
equivalent $ (in millions)	1876.0	1696.0	181.0	108.0
4. Reimbursements				11.2
1986				(8.3)
1987 (9 months)[4]				(2.3)
Equivalent $ (in millions)				29.0
1986 ($1 = GF 350)				(24.0)
1987 ($1 + GF 420)				(5.0)
Total (3+4) in GF	46.9	42.4	52.5	58.7
in $	1876.0	1696.0	181.0	137.0

1 consolidated balance sheet of the state banks before refaction

2 Consolidated balance sheet of the state banks after refaction

3 Consolidated balance sheet of the state banks after adjustment of the claims denominated in foreign exchange on the basis of the exchange rate on the second market in December 1985.

4 Reimbursements during the first nine months extimated at three quarters of the total reimbursement for the year.

GUINEA: Reimbursement of deposits of the specialized banks (in billions of Guinean francs)

Reimbursements	1986	1987	Jan/July '88	Total
Private sector	3.8	1.5	0.9	6.2
less than GF 500,000	(2.6)	(0.4)	(0.6)	(3.6)
above GF 50,000	(1.2)	(1.1)	(0.3)	(2.6)
Public sector	4.0	0.5	0.3	4.8
enterprises	(2.2)	(0.4)	(0.3)	(2.9)
local administration	(0.6)	-	-	(0.6)
other	(1.2)	(0.1)	-	(1.3)
Embassies	0.6	0.4	0.2	1.2
Foreign correspondents	0.3	0.7	0.1	1.1
Expenditures of the Liquidation Unit	0.1			0.1
TOTAL	8.8	3.1	1.5	13.4
Financing of Reimbursements				
Government allocation	4.5	-	-	4.5
Banks' own assets	1.8	0.5	0.5	2.9
cash in vaults	(0.2)	-	-	(0.2)
repayment of credits	(0.1)	(0.1)	(0.1)	(0.3)
Foreign correspondents	(1.5)	(0.4)	(0.4)	(2.3)
sales of equipment	-	-	-	-
Advance by BCRG	2.5	2.6	1.0	6.1
TOTAL	8.8	3.1	1.5	13.4

Source: BCRG and Liquidation Unit

Annex VII

Evolution of the Banking System from Jan. 86 through June 88
(end of period)

	Jan 86	Dec 86	Dec 87	June 88
Amounts				
Total Assets (GF billion)	na	43.6	71.7	89.7
Total Assets (US $ million)	na	109.0	162.9	190.8
Total Assets (in Constant GF) (base COLI Dec 86 = 100)	na	43.6	53.6	58.3
Total Deposits	6.4	27.1	41.4	55.1
Total Credits	3.0	13.5	28.7	38.1
In Percentage				
Deposits in GF	25.0	48.0	55.1	59.7
Deposits in Foreign Exchange	75.0	52.0	44.9	40.3
Total	100.0	100.0	100.0	100.0
Credit in GF	30.0	75.6	78.0	77.7
Credit in Foreign Exchange	70.0	24.4	22.0	22.3
Total	100.0	100.0	100.0	100.0
Public Sector Deposits	na	30.3	30.4	36.3
Private Sector Deposits	na	69.7	69.6	63.7
Total	-	100.0	100.0	100.0
Credit to Public Sector	na	2.2	3.1	1.3
Credit to Private Sector	na	97.8	96.9	98.7
Total	-	100.0	100.0	100.0
Short Term Credit	na	95.6	91.6	86.4
Medium Term Credit	na	4.4	8.4	13.6
Total	-	100.0	100.0	100.0
Demand Deposits	na	na	83.3	72.6
Time Deposits	na	na	16.7	27.4
Total	-	-	100.0	100.0
Assets in Foreign Exchange as % of Total Assets		58.3	56.5	52.5
Liabilities in Foreign Exchange as % of Total Liabilities		53.3	45.1	40.3

Source: Commercial Banks

GUINEA: Profit and Loss Statement of the Commercial Banks
(Financial year 1987, in million of Guinean francs)

	BIG	BIAG	BICIGUI	SGBG	Total
Interest Received	334	975	2,510	1,362	5,181
from banks	-	(505)	(414)	(134)	(1,053)
from customers	(334)	(470)	(2,096)	(1,228)	(4,128)
Commisions Received	383	979	1,669	1,303	4,334
on contingent liabilities	na	(61)	(257)	(557)	
on foreign exchange operations	na	na	(689)	(470)	
on other operations	na	na	(723)	(276)	
Total operating income	717	1,954	4,179	2,665	9,515
Less:					
Interest paid	210	35	342	72	659
to BCRG	na		(179)	(18)	
to banks	na	(3)	(28)	(4)	
to customers	na	(32)	(135)	(50)	
overheads	355	1,263	2,101	1,288	5,007
personnel expenses	(160)	(393)	(982)	(618)	(2,153)
other	(195)	(870)	(1,119)	(670)	(2,854)
Net operating income	152	656	1,736	1,305	3,849
Depreciation	8	213	329	105	655
Provisions	130	234	1,886	564	2,874
Net Profit	14	149	-479	636	320

Source: Commercial Banks

Annex IX

Some Ratios Pertaining to the Guinean Banking System
for Financial Year 1987 and for (first semester 1988)

in billions of GNF	BIG	BIAG	BICIGUI	SGBG	Total
Avg. total assets	7.4(8.0)	13.0(18.1)	21.7(31.4)	15.5(23.2)	57.6(80.7)
Avg. banking assets	7.3(7.9)	12.6(17.6)	17.8(26.6)	14.7(22.2)	52.4(74.3)
Avg. deposits	2.1(2.6)	10.4(13.6)	13.6(20.7)	8.1(11.3)	34.2(48.2)
Avg. credits	3.8(5.0)	2.7 (5.2)	7.9(11.7)	6.7(11.5)	21.1(33.4)
operating income					
as % of:					
Avg. total assets	9.7 (na)	15.0 (na)	19.3(13.8)	17.2(15.9)	16.5
Avg. banking assets	9.8 (na)	15.5 (na)	23.5(16.3)	18.1(16.6)	18.1
Net operating income					
as % of:					
Avg. total assets	2.1 (na)	5.0 (na)	8.0 (3.8)	8.4 (6.6)	6.7
capital funds	10.1 (na)	72.9 (na)	43.4(28.7)	81.6(76.6)	48.1
Interest received					
from:					
customer/avg credits	8.7 (na)	17.9 (na)	26.5(24,6)	18.3(20.1)	19.4
Commissions as					
% of:					
avg. total assets	5.2 (na)	7.5 (na)	7.7 (4.6)	8.4 (5.7)	7.5
operating income	53.4 (na)	50.1 (na)	39.9(33.6)	48.9(35.9)	45.3
overheads	107.9 (na)	77.5 (na)	79.4(55.3)	101.1(83.5)	86.0
Int. paid to					
customers as					
% of avg. deposits	(na)	0.3 (na)	1.0 (1.7)	0.6 (1.5)	na
overheads as % of:					
total avg. assets	4.8 (na)	9.7 (na)	9.7 (8.4)	8.3 (6.8)	8.6
Personnel expenses					
as % of:					
overheads	45.0 (na)	31.1 (na)	46.7(50.6)	48.0(49.7)	43.0

Source: Commercial Banks

Annex V

	BIG	BIAG	BICI-GUI	SGBG	UIBG
Capital		Expressed in FF and paid to an account with BIAO Paris.	Expressed in $US for an interim period and paid up in $US.	Expressed and paid up in FF.	Expressed in GF, paid in FF by Credit Lyonnais, in GF by Guinean subscribers.
Tax exemptions applicable to the bank	All taxes on profits, properties, turnover salaries, and imports for seven to 25 years.	All taxes on profits, properties, turnover, salaries, and imports for eight years.	All taxes on profits, properties, turnover salaries, and imports for eight years.	All taxes, duties fees, relating to the bank's activities, properties and vehicles for three years. Subject to some local taxes.	All taxes on profit and property, turnover salaries, imports for three years.
Tax exemptions applicable to foreign shareholders	All taxes on dividends and other payments for 12 years and 50 percent exemption for 13 years afterwards. All capital gains without time limit. Applicable to all shareholders, directors, and creditors.	No withholding tax on dividends, no tax on capital gains for eight years. No fees or tax on registration of share transfers.	All taxes on dividends, capital gains, registration fees on transfers, and subscriptions of shares. Applicable to all shareholders for 15 years with possible extension for five years.		All taxes and registration fees dividends for three years.
Tax exemptions applicable to foreign staff	Income tax, property tax on main residence, custom duties for five years after arrival.	Tax on salaries for eight years from date of arrival. Custom duties on personal and household effects for eight years. Property taxes on main residence for eight years.	Income tax or tax on salary for eight years. Custom duties on personal effects and imported goods.	Income tax for three years. Custom duties on vehicles and household effects.	Income tax for three years. Custom duties on personal and household effects for one year after arrival.

Annex V

Guinea: Agreements Between the Authorities and the Banks

	BIG	BIAG	BICI-GUI	SGBG	UIBG
Parties to the Agreement	People's Republic of Guinea Guinea Dah Al Maal Ae Islami (Bahamas)	People's Republic of Guinea Banque Internationale Pour l'Afrique occidental BIAD	Republic of Guinea BICI-GUI	Republic of Guinea Societe generale Bahn and Co.	Republic of Guinea U.I.B.G.(Guinea)
Date	22-02-1982	18-06-1985	11-11-1985	14-11-1985	
Duration	Seven to 25 years depending on provisions.	Eight year and possible extension.	Eight or 15 years depending on provisions and possible extension for five years.	Three years	Three years and possible extension for two years.
Revision clause	Yes	Yes	No	No	Yes
Arbitration clause	Yes. Under aegis of International Chamber of Commerce in Paris.	Yes. Under aegis of International Chamber of Commerce in Paris.	Yes. If no agreement on name of arbitrator, one is appointed by President of International Court of Justice in the Hague.	No	No, except with regard to tax exemption on dividends paid to foreign shareholders. (CIRDI in Washington)
Most favored institution clause	No	Yes	Yes	No	Yes

	BIC	BIAC	BICI-GUI	BOBG	UIBG
Recruitment and Training of staff.	Freedom of recruitment. Training of local staff.	Local staff given priority at equal level of competence. Training and promotion of local staff.	Training and promotion of local staff. Foreign staff limited to 15 percent of local staff for three years, five percent after three years.	Local staff given priority at same level of competence. Training and promotion of local staff. Foreign staff limited to 15 percent of local staff for the first three years and five percent afterwards.	Local staff given priority at same level of competence. Training and promotion of local staff.
Branch network			Should gradually establish a branch in each of the seven provinces of the country.		Extension of agreement will take into consideration policy of creation of branches.
Special		Account kept in FF until institutions start operating on domestic market, after monetary reform or after eight years, whichever comes first. Special reserves as provided in banking limited to five percent of annual profits instead of 10 percent guarantee of 20 percent of foreign trade operations. Depreciation allowance during period of tax exemptions deducted from taxable profits after end of exemp-	No penalty applicable compliance with reserve requirements.		

GUINEA: Reimbursement of deposits
of the specialized banks
(in billions of Guinean francs)

Reimbursements	1986	1987	Jan/July '88	Total
Private sector	3.8	1.5	0.9	6.2
less than GF 500,000	(2.6)	(0.4)	(0.6)	(3.6)
above GF 50,000	(1.2)	(1.1)	(0.3)	(2.6)
Public sector	4.0	0.5	0.3	4.8
enterprises	(2.2)	(0.4)	(0.3)	(2.9)
local administration	(0.6)	-	-	(0.6)
other	(1.2)	(0.1)	-	(1.3)
Embassies	0.6	0.4	0.2	1.2
Foreign correspondents	0.3	0.7	0.1	1.1
Expenditures of the Liquidation Unit	0.1			0.1
TOTAL	8.8	3.1	1.5	13.4
Financing of Reimbursements				
Government allocation	4.5	-	-	4.5
Banks' own assets	1.8	0.5	0.5	2.9
cash in vaults	(0.2)	-	-	(0.2)
repayment of credits	(0.1)	(0.1)	(0.1)	(0.3)
Foreign correspondents	(1.5)	(0.4)	(0.4)	(2.3)
sales of equipment	-	-	-	-
Advance by BCRG	2.5	2.6	1.0	6.1
TOTAL	8.8	3.1	1.5	13.4

Source: BCRG and Liquidation Unit

Annex VII

Evolution of the Banking System from Jan. 86 through June 88
(end of period)

	Jan 86	Dec 86	Dec 87	June 88
Amounts				
Total Assets (GF billion)	na	43.6	71.7	89.7
Total Assets (US $ million)	na	109.0	162.9	190.8
Total Assets (in Constant GF) (base COLI Dec 86 = 100)	na	43.6	53.6	58.3
Total Deposits	6.4	27.1	41.4	55.1
Total Credits	3.0	13.5	28.7	38.1
In Percentage				
Deposits in GF	25.0	48.0	55.1	59.7
Deposits in Foreign Exchange	75.0	52.0	44.9	40.3
Total	100.0	100.0	100.0	100.0
Credit in GF	30.0	75.6	78.0	77.7
Credit in Foreign Exchange	70.0	24.4	22.0	22.3
Total	100.0	100.0	100.0	100.0
Public Sector Deposits	na	30.3	30.4	36.3
Private Sector Deposits	na	69.7	69.6	63.7
Total	-	100.0	100.0	100.0
Credit to Public Sector	na	2.2	3.1	1.3
Credit to Private Sector	na	97.8	96.9	98.7
Total	-	100.0	100.0	100.0
Short Term Credit	na	95.6	91.6	86.4
Medium Term Credit	na	4.4	8.4	13.6
Total	-	100.0	100.0	100.0
Demand Deposits	na	na	83.3	72.6
Time Deposits	na	na	16.7	27.4
Total	-	-	100.0	100.0
Assets in Foreign Exchange as % of Total Assets		58.3	56.5	52.5
Liabilities in Foreign Exchange as % of Total Liabilities		53.3	45.1	40.3

Source: Commercial Banks

GUINEA: Profit and Loss Statement of the Commercial Banks
(Financial year 1987, in million of Guinean francs)

	BIG	BIAG	BICIGUI	SGBG	Total
Interest Received	334	975	2,510	1,362	5,181
from banks	-	(505)	(414)	(134)	(1,053)
from customers	(334)	(470)	(2,096)	(1,228)	(4,128)
Commisions Received	383	979	1,669	1,303	4,334
on contingent liabilities	na	(61)	(257)	(557)	
on foreign exchange operations	na	na	(689)	(470)	
on other operations	na	na	(723)	(276)	
Total operating income	717	1,954	4,179	2,665	9,515
Less:					
Interest paid	210	35	342	72	659
to BCRG	na		(179)	(18)	
to banks	na	(3)	(28)	(4)	
to customers	na	(32)	(135)	(50)	
overheads	355	1,263	2,101	1,288	5,007
personnel expenses	(160)	(393)	(982)	(618)	(2,153)
other	(195)	(870)	(1,119)	(670)	(2,854)
Net operating income	152	656	1,736	1,305	3,849
Depreciation	8	213	329	105	655
Provisions	130	234	1,886	564	2,874
Net Profit	14	149	-479	636	320

Source: Commercial Banks

Annex IX

Some Ratios Pertaining to the Guinean Banking System
for Financial Year 1987 and for (first semester 1988)

in billions of GNF	BIG	BIAG	BICIGUI	SGBG	Total
Avg. total assets	7.4(8.0)	13.0(18.1)	21.7(31.4)	15.5(23.2)	57.6(80.7)
Avg. banking assets	7.3(7.9)	12.6(17.6)	17.8(26.6)	14.7(22.2)	52.4(74.3)
Avg. deposits	2.1(2.6)	10.4(13.6)	13.6(20.7)	8.1(11.3)	34.2(48.2)
Avg. credits	3.8(5.0)	2.7 (5.2)	7.9(11.7)	6.7(11.5)	21.1(33.4)
operating income as % of:					
Avg. total assets	9.7 (na)	15.0 (na)	19.3(13.8)	17.2(15.9)	16.5
Avg. banking assets	9.8 (na)	15.5 (na)	23.5(16.3)	18.1(16.6)	18.1
Net operating income as % of:					
Avg. total assets	2.1 (na)	5.0 (na)	8.0 (3.8)	8.4 (6.6)	6.7
capital funds	10.1 (na)	72.9 (na)	43.4(28.7)	81.6(76.6)	48.1
Interest received from:					
customer/avg credits	8.7 (na)	17.9 (na)	26.5(24,6)	18.3(20.1)	19.4
Commissions as % of:					
avg. total assets	5.2 (na)	7.5 (na)	7.7 (4.6)	8.4 (5.7)	7.5
operating income	53.4 (na)	50.1 (na)	39.9(33.6)	48.9(35.9)	45.3
overheads	107.9 (na)	77.5 (na)	79.4(55.3)	101.1(83.5)	86.0
Int. paid to customers as % of avg. deposits	(na)	0.3 (na)	1.0 (1.7)	0.6 (1.5)	na
overheads as % of:					
total avg. assets	4.8 (na)	9.7 (na)	9.7 (8.4)	8.3 (6.8)	8.6
Personnel expenses as % of:					
overheads	45.0 (na)	31.1 (na)	46.7(50.6)	48.0(49.7)	43.0

Source: Commercial Banks

GUINEA: Profit and Loss Statement of the Commercial Banks
(First semester 1988 in millions of Guinean francs)

	BICIGUI	SGBG
Interest received	1,437	1,181
from banks	-	(25)
from customers	(1,437)	(1,156)
Commisions received	727	660
on contingent liabilities	(177)	(167)
on foreign exchange operations	-	(317)
on other operations	(550)	(176)
Total operating income	2,164	1,841
Less:		
Interest paid	247	285
to BCRG	-	(192)
to banks	(66)	(8)
to customers	(181)	(85)
overheads	1,315	790
personnel expenses	(666)	(393)
other	(643)	(397)
Net operating income	602	766
Depreciation	na	63
Provisions	na	494
Net profit	na	202

Statement for BIG and BIAG not available

Source: BICIGUI and SGBG

FINANCIAL SECTOR RESTRUCTURING IN GHANA:

A Report and Recommendation of the President of the International Development Association

June 20 - 22, 1989

The Madison Hotel
Washington, DC

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GHANA

FINANCIAL SECTOR ADJUSTMENT CREDIT

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GHANA

FINANCIAL SECTOR ADJUSTMENT CREDIT

Credit and Project Summary

Borrower: Republic of Ghana

Credit Amount:
IDA: SDR 72.1 million (US$100 million equivalent)

Terms : Standard IDA terms with 40 years maturity

Program Description: The credit would support a comprehensive and far-reaching Government program for the development of a well functioning and broadly-based financial sector, through the implementation of in-depth policy and institutional reforms. An action program has been prepared with Bank assistance to cover the 1988-1990 period and to be supported by the proposed credit. The main objectives of the program are (i) the enhanced soundness of banking institutions, through an improved regulatory framework, strengthened banking supervision by the Central Bank (Bank of Ghana), and the restructuring of financially distressed banks, (ii) improved deposit mobilization and increased efficiency in credit allocation, and (iii) development of money and securities markets.

Program Benefits: The reform program is expected to foster the development of a strong, efficient, and responsive financial sector, with an effective banking system at its core, to provide the needed support for the ongoing structural adjustment effort. The liberalization of interest rates and removal of sectoral ceilings will greatly contribute to enhancing the efficiency of financial intermediation by channeling savings to higher yielding investments. The restructuring of financially distressed banks, training programs for their employees, and improvement in the supervision by the Bank of Ghana should ensure the soundness of future banking activities and increase confidence in the banking system. The development of money and capital markets and an initial program for corporate restructuring would stimulate private investment. The reform program would also provide for the development of the profession of auditors and accountants.

Program Risks: The main risk relates to the inherent complexity of undertaking a sector-wide restructuring of the banking system which requires the strong commitment of the Ghanaian authorities as well as the full cooperation of the banks' management. Other risks include the timely and adequate availability of resources, and the strain the project will place on the country's implementation capabilities.

These risks are, however, mitigated by (a) the Government's commitment to undertake banking restructuring on a sound basis, in accordance with principles formulated in consultation with IDA, and to seek IDA's agreement on individual restructuring plans prior to their implementation; (b) the tranching of the credit, which would further ensure satisfactory progress in the implementation of the sector reform program overall, and of banking restructuring in particular; and (c) finally, the sector reforms contained in the Action Program, in particular the liberalization of interest rates, the improvement of the regulatory framework and strengthening of Central Bank supervisory functions, which are expected to go a long way in ensuring the future competitiveness, efficiency, and soundness of the banking system.

Financing Plan:

	(US$ million)
IDA	US$100
Cofinanciers	US$140
Government (1)	US$ 60
Private Sector	US$ 25
	US$325

(1) Principally through the conversion of loans into equity/quasi-equity and repurchase by Government of Ghana (GOG) of non-performing loans to state-owned enterprises (SOEs).

Estimated Disbursements: The credit would be disbursed in three tranches: The first tranche of US$45 million equivalent would be available upon effectiveness, the second of US$30 million after a first performance review to be held around February 1989 and the third tranche of US$20 million equivalent after a second performance review to be held around December 1989. IDA's disbursements have been adjusted to take into consideration the fact that contributions from two main other donors, Japan (US$55-70 million equivalent), and African Development Bank (AfDB--US$50 million equivalent) would be available for second and third tranches only. Disbursements of the US$5 million equivalent technical assistance component are not tranched, but will be monitored through an implementation schedule.

Staff Appraisal Report: This is a combined President's and Appraisal Report.

Map: No. 18112R1

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INTERNATIONAL DEVELOPMENT ASSOCIATION
REPORT AND RECOMMENDATION OF THE PRESIDENT
OF THE INTERNATIONAL DEVELOPMENT ASSOCIATION TO THE
EXECUTIVE DIRECTORS ON A PROPOSED DEVELOPMENT
CREDIT TO THE REPUBLIC OF GHANA FOR A
FINANCIAL SECTOR ADJUSTMENT PROJECT

1. I submit the following report and recommendation on a proposed development credit for the equivalent of SDR 72.1 million (US$100 million equivalent) to the Republic of Ghana on standard IDA terms to help finance a Financial Sector Adjustment Project.

I. THE ECONOMY

A. Background

2. A report entitled Ghana: Policies and Issues of Structural Adjustment (Report No. 6635-GH) was distributed to the Executive Directors in March 1987. Key economic indicators appear in Annex 1-1.

3. Ghana once enjoyed a high standard of living compared with most other West African nations. But drought, poor economic policies, and increases in oil prices led to a significant decline in per capita income during the 1970s and early 1980s. Ever since the inception of the Economic Recovery Program (ERP) in 1983, however, GDP growth has averaged above 5% a year, about 2% over the growth rate of the population. But the per capita income remains low at $380 (1985), and an estimated half of the population lives in absolute poverty (Annex 1-1).

4. The country is well endowed with natural and human resources. Agriculture accounts for 41% of GDP and provides income for about 70% of the population. Ghana is the world's third largest producer of cocoa, which accounts for about two-thirds of the country's export earnings. The country also possesses valuable mineral deposits, particularly gold, and hydropower generates most electricity, some of which is exported to neighboring countries. Manufacturing output increased substantially after Independence in 1957, due to government policies that encouraged import substitution industries behind a wall of protection. Services, which account for over a third of GDP, are dominated by retail and wholesale trade.

B. The Economic Recovery Program

5. Between 1970 and 1982, per capita income in Ghana declined by 30%, import volumes fell by a third, real export earnings halved, domestic savings and investment fell to almost negligible levels, and inflation ran at an average of 44% a year. In 1983, the newly constituted Provisional National Defense Council (PNDC) introduced an Economic Recovery Program to reverse the decline in living standards and restore growth to the economy.

6. The ERP's major objectives were to: (a) shift relative prices in favor of production, particularly for exports and efficient import substitution; (b) restore fiscal and monetary discipline; (c) initiate the restoration of the country's social and economic infrastructure; and (d) encourage private investment. The centerpiece of the reform was a move to

introduce a more realistic exchange rate. The cedi was devalued from 2.75 cedis to the U.S. dollar in April 1983 to 90 cedis to the U.S. dollar by January 1986. In September 1986, the Government introduced a second tier auction system, and in February 1987 the auction and official exchange rates were officially unified. Initially the auction was limited to producer goods, but its coverage has been expanded steadily, and by February 1988 all imported goods were eligible for funds from the auction. Administered prices, particularly cocoa and petroleum, have been adjusted at regular intervals to reflect changes in the exchange rate, and widespread price and distribution controls have been abolished. Interest rates were adjusted upwards steadily, and finally in September 1987 all interest rates except those for savings deposits were liberalized. In the area of fiscal policy, the Government's efforts have concentrated on eliminating subsidies, mobilizing resources through improved tax collection and selective increases in taxes, and providing more adequately for maintenance and capital expenditures. In addition, the Government raised public sector wages and salaries to offset partially the drastic erosion of real incomes in previous years. At the same time, it reversed the previous severe compression of salary differentials between the lowest and highest paid members of the civil service.

7. The response of the economy was crippled initially by the drought in 1983 and insufficient aid flows. Since 1984, however, performance improved on several counts. Growth averaged over 5% a year, the Government's fiscal position improved markedly, the rapid growth of the money supply was curbed, and the trade balance improved substantially (Annex 1-2). In addition, the Government introduced significant improvements in public expenditure policies. It initiated rehabilitation programs for infrastructure in the cocoa, timber, gold, and transport sectors. At the same time, the Government prepared a rolling three-year development program based on reviews of public expenditures conducted jointly with IDA. At this stage, the high level of inflation (39% in 1987) remains a major concern. The main reasons are (i) the significant devaluation of the currency in 1986, (ii) the decline in food production, (iii) the increase in domestic petroleum prices, (iv) a 50% rise in M2 in the latter half of 1986. However, there are signs that inflation is decelerating. The national consumer price index rose only 5.1% in the second semester of 1987.

8. The second phase of the Government's ERP (sometimes termed the Structural Adjustment Program) is currently under implementation and has as its principal objectives continued economic growth, sustained fiscal and monetary discipline, increased levels of domestic savings and investment, improvements in the efficiency of public resource management, and further development of the private sector. To achieve these goals, the Government is moving on five broad fronts. It is progressively liberalizing its trade and exchange rate policies by expanding the official foreign exchange market to include banks and authorized dealers, and by rationalizing the structure of trade taxes and tariffs. To maintain recent production gains in the cocoa sector, additional incentives are being provided for cocoa producers and steps are being taken to improve the efficiency of COCOBOD's operations. The Government is improving public resource management by further improvements in tax policy and administration and in refining the public expenditure planning process. The efficiency of the public sector is being enhanced through a reform of the state-owned enterprise sector, which includes policy changes to encourage the commercial operation of SOEs, rehabilitation of priority SOEs, and a divestiture program for SOEs through liquidation or outright sale to

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the private sector. And finally, the Government is improving its management of the public sector by reducing the number of surplus civil servants, recruiting skilled Ghanaians to strengthen policy planning and coordination in the higher reaches of the Government, and providing logistical support to agencies responsible for implementing the Structural Adjustment Program.

9. Ghana's total external debt in 1987 was estimated at US$2.6 billion, including 1.76 billion medium and long-term foreign debt. According to IMF and World Bank estimates, the country's foreign debt is likely to increase over the years, reaching 3.24 billion in 1990 and 4.6 billion in 1995, with medium and long-term debt reaching 2.49 and 3.74 billion, respectively. In 1987, the debt service ratio excluding IMF and arrears was 26.3% (60.5% including IMF debt service and payment of arrears), down from 37.4% the previous year. However, this debt-service ratio is expected to decline steadily in the future, reaching 30.1% (including IMF debt-service and payments of arrears) by 1990 (Annex 1-3).

10. To support the ongoing reforms, and to facilitate the restructuring and rehabilitation of the economy, Ghana needs an efficient and dynamic financial sector that both mobilizes domestic resources and allocates them efficiently to different sectors of the economy. However, like some other sectors of the economy, the formal financial sector remains burdened by the legacy of its past, and is consequently unable to cope with the demands placed upon it by the Structural Adjustment Program. The banking system, in particular, faces severe financial difficulties, which if left unaddressed, could hamper the future progress of the economy, and constrain seriously the supply response to the new incentive framework that the Government has introduced. To address these problems, and to place the entire financial system in Ghana on firmer foundations, the Government has prepared a comprehensive financial sector action program that it has already begun to implement. The proposed credit would support the implementation of the program and finance technical assistance to strengthen key financial institutions.

C. Medium-Term Prospects

11. The Government's medium-term objectives, as stated in its policy framework paper, are to achieve an annual average growth rate of real GDP of about 5%, reduce the inflation rate to 8% by 1990, and maintain a healthy balance of payments position after meeting its program for the liquidation of external arrears. The GDP growth target of 5% per year will require a strong performance from both agriculture and industry. In agriculture, cocoa is expected to continue its recovery, and the prospects for food and industrial crops appear bright. And in the industrial sector, the rehabilitation of Ghana's mines will permit the steady expansion of mining output, and manufacturing is projected to respond to improved incentives and the greater availability of spare parts and inputs. Ghana's macroeconomic prospects, however, are contingent upon a continuation of its present structural adjustment program and a favorable international economic environment, particularly for its principal exports of cocoa and gold. In addition, the expansion of the economy will depend crucially on the availability of concessional assistance at the projected levels.

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II. THE FINANCIAL SECTOR

A. Background

12. Work on Ghana's financial sector began some two years ago, as the structural adjustment process was underway, because the financial system appeared to be potentially a serious constraint to growth in the real sectors. This culminated in a major review in April 1987 by a joint "working group" of Ghanaians and Bank staff which identified key problems and proposed a wide ranging program of reforms (the Action Program) which the present operation intends to support.

B. The Structure of the Financial Sector

13. The formal financial system is dominated by three primary commercial banks (the Ghana Commercial Bank (GCB), the Standard Chartered Bank of Ghana (Standard), and the Barclays Bank of Ghana (Barclays)), seven secondary banks (the Social Security Bank (SSB), the Bank of Housing and Construction (BHC), the Agricultural Development Bank (ADB), the National Savings and Credit Bank (NSCB), the National Investment Bank (NIB), the Merchant Bank, and the Bank of Credit and Commerce), a small cooperative bank, Ghana Cooperative Bank (Coop Bank), and over one hundred rural banks. Of the total assets of the banking system of around 156 billion cedis (about 25% of GDP), some 57% are in the three primary banks, although the secondary and rural banks have been growing faster. All the primary and secondary banks accept deposits from the public and with the exception of the Bank of Credit and Commerce, are either partly or wholly owned by the Government. Annex 2-1 details the aggregate assets and liabilities of the banking system.

14. The three government-owned development finance institutions have increased their level of commercial banking activity in recent years, and at the end of 1986, one-quarter of their outstanding liabilities was accounted for by demand, savings, and time deposits. Nevertheless, they face serious financial difficulties arising from a huge foreign exchange exposure and/or loss, a substantial non-performing portfolio, and a complete erosion of net worth.

15. The rural banks are owned and managed by their respective local communities. They are private unit banks established to mobilize resources in rural areas and extend credit locally. The Bank of Ghana has usually contributed to the initial capital of each rural bank with the intention of divesting its holdings to the private owners at a later stage. Despite the large number of rural banks, the rural banking sector accounts for under 3% of the total deposits mobilized by the banking system as a whole. A large number of rural banks are in financial difficulties, but their "unit" nature has contained the effect of this problem on the banking system.

16. The money market is composed of the recently opened Consolidated Discount House Ltd. The Discount House is charged with the task of acting as an inter-bank intermediary for short-term assets to enable banks to manage better their liquidity position. The Consolidated Discount House is permitted to deal in treasury bills, short-dated government securities, bankers' acceptances, cocoa bills, negotiable short term certificates of deposit, and commercial paper.

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17. Ghana possesses a very rudimentary capital market that has been unable to make a substantial contribution to the mobilization of long term resources. The few transactions that occur are usually in long dated government stock, and shares of private companies change hands occasionally. The National Trust Holding Company quotes shares of eighteen companies on a monthly basis, but its insufficient capital base and the limited number of tradeable shares in the system have prevented it from playing a more active part in capital market transactions.

18. The remaining non-banking sector is limited principally to the Social Security and National Insurance Trust (SSNIT) and eleven insurance companies. SSNIT is a government-owned institution charged with providing social security payments to workers upon their retirement from service. All enterprises with five or more employees must become members of SSNIT and contributions amount to 17.5% of the wage bill, 5% of which are contributed by workers and 12.5% by employers. Out of a membership of 1.5 million, however, only about 600,000 pay their monthly dues. Until late 1986, SSNIT was compelled to invest its funds in government stock specially created for it, yielding 5.5% to 6%, but it now has the freedom to invest its funds in assets of its own choosing. As a result it has been a major purchaser of treasury bills and long dated government securities.

19. Like the rest of the economy, the banking system in Ghana has suffered adversely from the generally low-level of productive activities during the period of economic decline, although a few institutions are reportedly profitable and relatively efficient. Its current distressed situation can be characterized inter alia by (i) huge non-performing loan portfolios, (ii) inadequate provisions for portfolio losses, (iii) inflated profits, (iv) high operational costs, (v) potential/actual foreign exchange exposure, (vi) insolvency, (vii) capital inadequacy, and (viii) inadequate accounting systems, management information and internal controls. Comprehensive external diagnostic audits by international auditors have been undertaken for the nine main banks (GCB, SSB, Barclays, BHC, NIB, ADB, Standard, NSCB and Coop Bank) to obtain an indepth and accurate assessment of the operating and financial condition of each of these banks, and provide a basis for determining their restructuring prospects and requirements.

C. The Policy and Regulatory Framework

1. Deposit Mobilization

20. The formal financial system has not proved an effective vehicle for mobilizing domestic resources. The M2/GDP ratio in Ghana is low by international standards, and indicates the low level of financial intermediation in the economy (Annex 2-2). During the 1970s and early 1980s, liquidity expansion was fuelled by large government deficits financed domestically by the Central Bank. Excessive money creation at a time of stagnant growth and investment stoked inflation and turned government-determined deposit rates deeply negative in real terms. In addition, the lack of longer term lending opportunities provided few incentives for banks to attract term savings. Instead those with surplus funds tended to invest in inflation-hedged assets such as real estate.

21. Since 1983, the Ghanaian authorities have pursued a flexible interest rate policy aimed at mobilizing domestic savings (Annex 2-3), in line with their growth and stabilization objectives. Accordingly, minimum

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rates for savings and time deposits were adjusted upwards repeatedly from 8.25%-9% in 1983 to 22%-23% in 1987.. In addition, declining inflation during this period as a result of fiscal and monetary discipline on the part of the Government helped turn real deposit rates positive for the first time in more than a decade. However, as the rate of inflation climbed in 1986 and 1987, real interest rates once again turned negative. In September 1987, the Government liberalized all interest rates except for savings deposits which have been pegged at a minimum of 21.5%. Full liberalization has been achieved in February 1988.

22. The disincentives to depositors during the 1970s and early 1980s arising from negative real interest rates were compounded by a series of ad hoc monetary measures which shook the confidence of the public in the banking system. These measures included the demonetization of 50 cedi notes, the freezing of bank deposit accounts in excess of 50,000 cedis and investigation for tax liability and possible corruption or fraud, the recall of bank loans for the financing of trading inventories, and the compulsory payment by checks for all business transactions in excess of 1,000 cedis. The immediate response by firms and individuals was to rechannel their financial resources into the unregulated informal financial sector.

23. There are signs that confidence in the banking system is returning gradually. Currency held outside the banking system as a proportion of narrow money fell to below 50% in 1986, and the Government's recent announcement that it would compensate those affected by the demonetization of the 50 cedi notes should serve to reinforce this trend. However, there remains a lingering distrust which can only be removed by assurances in word and deed that the Government will respect confidentiality of bank accounts, avoid undue interference in financial transactions, and take actions to preserve the sound financial health of banking institutions.

24. The poor record of deposit mobilization by the banking system can also be attributed to the inferior quality of customer services of a number of banks and the limited range of financial instruments aimed at mobilizing savings. In addition, banks find it difficult to improve the efficiency of their operations and reduce intermediation costs because of antiquated systems and procedures and the shortage of trained and qualified staff. The Bank of Ghana regulates charges that banks can levy on their customers, thereby curtailing competition between banks and reducing incentives to improve efficiency. The efficiency of banks is also affected by the lack of high denomination currency notes. The Bank of Ghana recently issued a 500 cedi note and plans to introduce a 1000 cedi note shortly. But a case can be made for yet higher denominations which can shorten queues in banks and reduce the costs of counting large wads of notes. As far as the branch network of the banks are concerned, the banks are required to obtain the permission of the GOB before altering their opening and closing hours. This practice reduces the ability of banks to respond effectively to the needs of their clientele, and could therefore be discontinued.

2. Credit Allocation

25. The BOG has been controlling the growth and allocation of credit by the banking system through global and sectoral credit ceilings. To determine the total quarterly credit expansion by any individual bank, the BOG first determines the overall rate of credit expansion consistent with projections of real economic growth and inflation. Until February 1988, sectoral growth

rates were established according to the development priorities of the Government, and guidelines were then issued to individual banks based on the application of these growth rates to the outstanding loans at the beginning of the period. The allocation for agricultural lending (20% of the total) was serving as a minimum whereas for other sectors it was usually a maximum. All sectoral lending targets have now been removed, except for agricultural lending.

26. Until recently lending rates also were controlled by the Bank of Ghana. Before 1986, agriculture was favored with preferential lending rates. But while this encouraged the demand for credit, it also discouraged the banks from lending to the sector, with the result that agricultural lending invariably fell short of the targets required of each bank. After 1986, however, lending rates were more or less unified, and in September 1987 lending rates were completely liberalized. Between September and December, lending rates appear to have barely moved and continue to be negative in real terms. Some rates have edged upwards, particularly for riskier loans, but despite excess liquidity in the banking system, the rate structure has not changed substantially because the binding credit ceiling precludes any further expansion of credit.

27. Partly as a result of interest rate controls, term transformation has been a problem for the Ghanaian banking system. Banks were unable to compensate for risk and maturity by varying their interest rates. In addition, the high proportion of banks' liabilities at the short end of the maturity structure (mainly demand deposits) have constrained their ability to lend long term. Furthermore, large holders of long term funds, such as the Social Security and National Insurance Trust, were compelled to purchase low yielding government stock to finance the government deficit. These constraints, along with the limited number of viable investment opportunities brought to the attention of the banks, served to hinder the flow of financial resources for investment. The banks have tended to lend short term, mainly to their established customers, a high proportion of whom are in the trade and service sectors. In 1986, it is estimated that only around 15% of commercial bank loans outstanding (including those of development finance institutions) were of maturities over three years, and nearly 50% of all loans were to trade and services (Annex 2-4).

3. Liquidity Management

28. In addition to quarterly credit guidelines, the BOG uses two kinds of minimum reserve ratios to control the expansion of credit. The first is a minimum cash reserve ratio that relates a bank's cash and deposit holdings with the BOG to its total deposits. And the second is a minimum liquidity reserve ratio that relates a bank's secondary holdings (approved bills and securities) to its total deposits. For many years the minimum reserve ratios were not effective in controlling liquidity because bank financing of the government deficit was far in excess of what could be absorbed at the prevailing reserve ratios. But with the rapid depreciation of the currency, the excess liquidity was soon mopped up and the BOG reduced its minimum cash reserve ratio gradually until it reached 10% on demand deposits and 5% on time and savings deposits in October 1986.

29. In late 1987, however, a situation of excess liquidity once again emerged. The banking system appears unable to absorb the net repayments by the Government, especially since it cannot rechannel these to the private

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sector on account of the credit ceilings. As a result, some banks have been turning depositors away, and private enterprises with surplus savings are finding means of lending to deficit enterprises directly rather than going through banking institutions. The "crowding out" of private sector financial savings was exacerbated by the substantial expansion of credit by the BOG to the cocoa sector which has added liquidity to the system adversely affecting as a result, the operations of the newly opened Discount House, and sending interest rates at the BOG's recently introduced treasury bill auction below the minimum savings rate and the rediscount rate.

30. The present situation of excess liquidity in the banking system is coincidental with a shortage of liquidity in parts of the manufacturing sector. The demand for credit in the manufacturing sector has risen sharply as a result of increased import costs, 100% deposit requirements for the foreign exchange auction, and improvements in the efficiency of tax collection. But the banking system has been unable to intermediate between the resource-rich cocoa and mining sectors and the resource-hungry manufacturing and foodcrops sectors. The distortions created by the credit ceilings are beginning to make it difficult for the Central Bank to manage liquidity, and this points to the need to develop as rapidly as possible indirect instruments for monetary management that are capable of absorbing or injecting liquidity as and when required. But the issue also goes beyond one of just introducing new instruments. It means that the financial sector needs to develop a secondary market in government backed securities and commercial paper, and use it to manage its twin objectives of liquidity and profitability. The Government is putting together a plan to address these issues, including the sale to commercial banks of cocoa bills, a better monitoring of banks' cash reserves and the timely issuance by BOG of short-term paper.

4. Money Market

31. The potential usefulness of a money market in Ghana has been recognized for some time, and one discount house, Consolidated Discount House Ltd (CDH), which is owned by banks and insurance companies, has recently become operational. After opening for business on 30th November 1987, however, and an initial flurry of activity during the first days, few transactions have subsequently been done by CDH. This disappointing performance can be traced to a combination of inadequate detailed agreement between CDH and BOG on an operational framework, unrealistic expectations by banks as to the absorptive capacity of CDH, and imprecise definition of the scope of CDH by all parties. The Ghanaian authorities are now in the process of taking the requisite steps to facilitate the development of a smoothly functioning money market. These will include consideration and resolution of the following defects and shortcomings: (i) prudential limits on the composition of CDH assets; (ii) liquidity status of money-at-call with CDH; (iii) CDH's method of computing interest; (iv) access by CDH to rediscount facility with BOG, or to any assured supply of treasury bills; (v) status of call money deposits by banks with CDH; (vi) the effect of the banking licence issued to CDH; (vii) continued access of banks to BOG for accommodation of their liquidity; (viii) definition of bankers' acceptances eligible for rediscount at BOG; (ix) BOG's policies for the sale to non-banks of bankers' acceptances; (x) further to (iv) basis on which CDH and BOG deal in longer-dated Government stock.

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5. Capital Market

32. Ever since the early 1960's, when a comprehensive companies code was enacted, Ghana has been considering the introduction of a formal Stock Exchange. The clear benefits of such an institution, in Ghana, as elsewhere, would be to enable corporate issuers to access long-term funds provided by investors, both individual and institutional, and to provide liquidity in the secondary market for shares and bonds. The Accra Securities Market Ltd (ASM) has been formed for some years, but not activated. Ghana, however, already has public issues of companies. Some eighteen companies, owned primarily by foreign shareholders, were converted into public companies during 1975 and 1976, under the operation of the Investment Policy Implementation Decree. The only other issues since 1976 have been one issue involving the capitalization of reserves, and a failed rights issue, which was less than 25% subscribed. It may be generally observed that these public companies, some of which are among the largest enterprises in the land, either have not needed to raise capital from the public during the last decade or have determined that it would not be available at a reasonable cost. It may be argued that the program of divestiture of state-owned enterprises could best be accomplished through a Stock Exchange. Indeed, if such an exchange existed, it would be a natural conduit for such transactions. However, it is unlikely to be satisfactory for either the Government, or the future development of the capital market in Ghana, for an Exchange to be created based mainly on such a short-term flow of captive business. Furthermore, divestiture sales are not primary issues, since no funds are raised for the subject company, unless the sales are combined with a new issue of stock by the company.

33. One practical way to test the proposition that both supply and demand in primary market will be available in quantity, is to provide some incentives to private placement of equities, and to monitor the resultant flow of investment. Incentives to corporate issues could range from elimination or reduction of the 2% stamp duty on capital increases, to a permanent or temporary reduction of the corporate tax rate for companies attracting new capital. Investors might be encouraged to make equity investments by exoneration from capital gains taxation, by equalization of the tax treatment of bank interest and dividends, or by the ability to make investments up to a stated maximum limit out of pre-tax income. It seems that dividends in Ghana were treated as tax-free for some years in the 1970s. In addition to the above consideration, there are a number of other concerns that need to be addressed. These include: (i) the review of auditing standards applicable to public companies should be accelerated, such that any recommendation for improvement may be implemented well in advance of any Stock Exchange activity; (ii) the institutional and regulatory framework for any Exchange must be devised and erected before any attempt is made to activate the ASM; (iii) the possibility of forming a vehicle for provision of venture or development capital could be considered, which would hold the prospect of acting as a nursery for companies which could, on maturity, be sold to public investors through the Exchange; and (iv) the pricing policy and mechanism for new issues on the ASM should, ideally, be left in the hands of professional advisers to corporate issuers. The Technical sub-committee for the Establishment of a Stock Exchange, reported in 1986 that a Capital Issues Commission, under the auspices of the Ghana Investments Centre (GIC), should fulfil this pricing function. Although such a proposal seeks to utilize the skills which are available within GIC to provide an objective

framework for price-setting, it may be seen by the manager and shareholders of potential issues as unduly prejudicial to their interests.

6. Regulatory Policies

34. Regulation is intended to provide monetary stability, protection of depositors, and an efficient and competitive financial system. In Ghana, banking activities are governed by the Banking Act of 1970, the Banking Regulations of 1973, the Bank of Ghana Act of 1963, and amendments or decrees issued in due course since the enactment of the foregoing legislation.

35. Several serious omissions in this body of legislation, together with weak bank supervision, have led to the concentration of risk in the portfolios of banks, inadequate capital and reserves, inflated profits, and unrecognized loan losses.

36. The BOG has never specified the limits for unsecured credit as a limit of each bank's paid-up capital and reserves. and has never specified the percentage, thus banks have frequently extended credit to single borrowers far in excess of the bank's capital funds in clear violation of prudent banking practice, and with the result that these borrowers, in effect, control the future of the banks.

37. Because banks in Ghana operate without the benefit of uniform accounting standards, their treatment of interest on non-performing assets varies. In many cases, banks continue to count interest on assets as income even when collection of such assets is in doubt. This implies necessarily that a uniform definition of non-performing assets must be established. The lack of uniform accounting standards has also led to inadequate loan loss provisions and reserves. Currently, most banks make no attempt to accurately quantify the risk which exists in their asset portfolios and to provide adequate loan loss reserves. Diagnostic studies of the banks clearly indicate the need for banks to better assess the quality of their assets. Mandatory minimum provisions should be established in order to ensure that management is not overly optimistic over the eventual collection or recovery of the asset when determining an adequate level of loan loss reserves.

38. The problem of assessing asset quality properly carries over to the issue of capital adequacy. Not only are banks failing to recognize loan losses and set aside adequate reserves, but their assets have grown at rates far surpassing the growth in capital funds through retained earnings. As a result, the proportion of capital to assets has become insufficient to prudently support the banks' ongoing operations. In fact, if banks were required to recognize the loan losses currently existing in their portfolios, many would be technically insolvent. Unfortunately, existing banking legislation does not mandate a minimum capital adequacy ratio which would ensure that banks grow at a controlled pace with due attention to asset quality and off-balance sheet risk.

39. Other weaknesses or omissions exist in the current body of banking legislation. Development finance institutions which are engaged in commercial banking activities are not subject to the same requirements regarding the transfer of retained profits to the reserve fund. Monetary penalties cited within the legislation have not been revised upward to reflect the effects of inflation and, therefore, no longer serve to discourage illegal or imprudent acts. Prudential reports and audit reports

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submitted to the Bank of Ghana are inadequate as sources of information with which to conduct off-site or early warning analysis. And a mechanism such as a credit clearing house does not exist to provide for the sharing of credit information between banks.

7. Banking Supervision

40. Supervision of the banking system is the responsibility of the Bank of Ghana, a function it provides through its Bank Examination Department. All banks, including rural banks, commercial banks, development finance institutions, and the discount house, come under its purview. Supervision is carried out through on-site examinations and off-site analysis of prudential returns. However, serious shortcomings exist in the Examination Department's capability to perform these tasks.

41. On-site examinations of each bank are required annually, yet only three banks were examined in the last year using comprehensive examination procedures. Furthermore, the three largest banks have never been examined in depth. Of the approximately 110 rural banks, only about 40 were examined. Implementation and enforcement of banking laws and regulations is ineffective and supervision weak. The existing examination methodology focuses primarily on a 'snapshot' of the bank's condition at a given point of time rather than on strengthening the bank's management systems which are the first line of defense against imprudent and/or illegal banking practice. Besides, prudential reporting is limited to a handful of reports, and notwithstanding the lack of suitable prudential reports, no capability has been developed for conducting offsite analysis even if the proper reporting framework was in place.

42. There are several reasons for the Bank Examination Department's deficiency in meeting its responsibilities. The present staffing of 45 persons includes approximately 30 examiners; however, only five are judged by the Head of the Department as being capable to lead examination teams. Of the thirty individuals, only one has more than ten years experience, and only four have experience of between five and ten years. Low civil service salary levels make it difficult for the Bank Examination Department to attract and retain qualified examiners. And training is inadequate given the very specialized skills needed by the bank supervision staff. If the Bank Examination Department is to meet its responsibilities, the number of staff must be increased, salaries improved, and both skills and experience levels strengthened.

III. AN AGENDA FOR ACTION

43. The development of an efficient and broadly-based financial sector is crucial for the continued adjustment effort of the Ghanaian economy. The Government has prepared a Statement of Financial Policy which details the policy framework for reforms to be undertaken (including an Implementation Schedule) which the proposed credit would support (Annex 4). The main objectives of this program are outlined below.

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A. Measures to Improve Deposit Mobilization and to Increase the Efficiency of Credit Allocation

1. Deposit Mobilization

44. A key factor in improving the deposit mobilization potential of the financial sector is to restore public confidence in the banking system. The Government is, therefore, considering the repeal of the Banking and Financial Institutions (Request for Information) Decree, with a view to stipulating that all disclosures of information from banks, including cases where criminal cases are pending in courts of law, will be in conformity with the Banking Act of 1970. In addition, the Government intends to amend the Banking Act of 1970 to incorporate provisions requiring the maintenance of secrecy in respect of customers' accounts by the banks' Directors, officers, staff, and auditors. The banks would also mount a public relations campaign to educate the public on the new laws and their implications for individual or corporate depositors, and thereby lessen any lingering fears about the maintenance of secrecy of bank accounts. Finally, measures to enhance the soundness of banking institutions under the proposed project will contribute towards the restoration of public confidence in the banking system. Consideration may be given to establishing a Deposit Insurance Scheme once the financial distress of banks has been alleviated and Government's shareholding in banks has been substantially reduced.

45. In recognition of the importance of improving customer services and as a means of mobilizing deposits, the banks will be permitted under a new regulation to vary the working hours and business days of their branches. This will allow them to respond flexibly to customer needs in different areas. In addition, the BOG intends to review the system for collecting and clearing local and outstation checks, with the principal aim of determining the reforms necessary to reduce substantially the extensive time and high costs involved in the present system.

46. The increased flexibility in the Government's policy towards interest rates has led to a discernible increase in the willingness of the public to hold deposits with the banking system. In addition, the BOG will agree with IDA on a timetable for decontrolling banking charges prior to February 1989.

2. Efficiency of Credit Allocation

47. The BOG has already taken the commendable step of liberalizing lending rates of banks. To follow up on this step, it issued on February 29, 1988 new credit guidelines abolishing all sectoral ceilings while maintaining the requirement that banks lend a minimum of 20% of their total lending to agriculture. BOG interprets 'agriculture lending' in the broad sense to include, beyond primary agriculture, the processing, warehousing, and marketing of agricultural produce as well as forestry activities. Prior to December 1989, the BOG will review the results of the recent liberalization of the credit policy and determine in consultation with IDA whether the floor on agricultural lending should be maintained. To ensure that refinancing facilities, special lines of credit, and other special credit schemes are used only in exceptional circumstances, the BOG will prepare criteria and mechanisms for their use. These criteria should ensure that such credits are only employed when it is clearly established that there is a market failure preventing funds from reaching disadvantaged or priority groups, and that the

most appropriate way of dealing with the market failure is through a special line of credit. If and when such credit schemes are used, they will be kept to a minimum and their costs will be budgeted and made transparent. Finally, using similar criteria, the BOG will review the Credit Guarantee Scheme and in consultation with IDA, determine whether the scheme should be wound up. In the meantime, the scheme will not issue any further guarantees.

3. Efficiency of Banking Operations

48. To encourage banks to improve the efficiency of their operations yet further, the BOG will undertake a review of their operating practices with the aim of preparing and circulating semi-annually a set of average efficiency indicators so that banks can compare their performance vis-a-vis other banks. In addition, to reduce the costs of banking operations that arise from low denomination currency note, the BOG will issue notes of higher denomination. Recently the BOG brought out the 500 cedi note, and a 1000 cedi note has been approved by the Board and the Government. The BOG will keep this policy under constant review and issue notes of yet higher denomination when and as necessary. Besides, the need for introducing more modern banking methods and technology, upgrading the skills of the existing personnel, and recruiting and developing of new talent, would necessitate training programs, which given their magnitude, would be better undertaken centrally to serve the entire banking industry. Technical assistance to that end would be financed under the project (Annex 3-6).

4. Money Market

49. The emerging money market in Ghana, the principal institutional member of which is the newly established CDH, is laboring under the difficulty of an inadequately defined operational and regulatory environment (para 31). The indicative list of problem areas for the money market, and CDH in particular, covers a wide spectrum. These problems would be addressed through the preparation and subsequent implementation of a priority reinforcement plan, to be implemented prior to February 1989, including the drafting of a Statement of Operating Policy for CDH to be endorsed by BOG and developed after careful consultation with banks, BOG and CDH management and supported by technical assistance financed under the proposed credit (Annex 3-1). Speed would be an important factor to avoid loss of impetus in CDH's development. Meanwhile, pending the implementation of the reinforcement plan, CDH's activities would be expected to be on a modest scale and limited principally to facilitating overnight transactions between banks and channelling of funds between the banking sector and BOG.

5. Capital Market

50. The concept of establishing a capital market in Accra, probably through Accra Securities Market Ltd (ASM), has been fostered for some time by the notion that a strong demand exists for such services from potential investors and corporate issuers. Quantification of these factors will always be imprecise, but it is necessary for the foundation of a capital market to be as secure as possible. Accordingly, an assessment of the likely demand for, and supply of, quoted securities should be made covering the primary and secondary markets. This assessment would be undertaken in a study financed under the proposed credit (Annex 3-2) which in addition would cover the following areas (i) design of a package of suitable incentives to attract both investors and potential corporate issuers; (ii) design of an adequate

regulatory and institutional framework to generate users confidence and prevent financial abuse; and (iii) assessment of the suitability of establishing a specialized financial institution providing venture and development capital. In the meantime, and pending the review of the study's outcome, no substantial action should be undertaken leading to major institutional changes in capital-market related institutions (ASM, National Trust Holding Company, the proposed Capital Issue Commission).

B. Amending Laws and Regulations

51. In order to strengthen the hand of banking supervisors, the existing body of laws, rules, and regulations will be amended or revised to address the serious shortcomings described earlier. To facilitate this, a committee has been established at the behest of the government to review existing legislation, draft the changes necessary to improve the regulatory framework, and establish prudent standards to ensure the viability of the banking system (even if this means that many banks may not immediately conform to the new legal requirements). To assist in the revision of this body of laws, rulings, and regulations, a technical assistance component is included in Annex 3-3 to provide for the employment of a banking law expert on an ad hoc basis.

52. GOG has agreed to a number of critical changes or additions to the legal framework. Risk exposure limits as a percentage of capital will be set on a bank's exposure to a single customer or related group. These limits will encompass secured as well as unsecured credit to (and investments in) a single party or group of related parties. To the extent that credits to existing customers exceed the new limits, the banks should establish plans to reduce them to conforming levels within a reasonable time frame. Modifications to existing legislation will also place stricter limits on credit extended to directors' interests by subjecting them to similar exposure limits based upon the bank's capital.

53. A minimum capital-adequacy ratio will be established. This ratio should take into account the riskiness of the bank's assets as well as its off-balance-sheet risk. Banking supervisors will have the ability to mandate even greater capital when, in their opinion, conditions warrant. Banks which do not meet the minimum guideline will not be allowed to pay dividends. Following implementation of new minimum capital guidelines, banks should prepare, and update on an annual basis, a capital plan for maintaining or restoring capital to an adequate level. In addition, the amount of paid-up capital to establish a new bank will be adjusted upwards to reflect the effects of inflation. The BOG will be delegated authority to revise this minimum amount as warranted. Development finance institutions which are engaged in commercial banking will also meet minimum capital adequacy requirements, although such limits may differ from commercial banks because of the added risk of the development portfolio. Development finance institutions will also be required to transfer a portion of their net profits to reserves in accordance with the relevant provisions of the Banking Act for commercial banks.

54. Regulations will specify the format and content of audit reports and the minimum scope of audit reviews. Uniform accounting and auditing standards and prudential reporting requirements will also be established. The accounting standards will include guidelines for loan portfolio review and classification, the treatment of interest on non-performing loans, and

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provisioning for potential loan losses. To assist in establishing these standards and reporting requirements, the project would finance the services of an international accounting firm.

55. The establishment of a credit clearing house is a complex undertaking which will require a technical advisor to consult on its establishment, operation, and legal framework. A technical assistance program is proposed in Annex 3-4.

56. Lastly, monetary penalties for violations of laws and regulations will be strengthened and periodically revised to serve as a deterrent to illegal and imprudent acts. Initially, the penalties contained in the existing Banking Act are to be increased by a factor of 100 and revised thereafter as needed.

C. Banking Supervision

57. To enable the BOG to effectively carry out its role of monitoring and preserving the health of the financial system, the skills, training, staffing, and methodology of its Bank Examination Department must be strengthened. To this end, a number of steps are being taken. First, two banking supervision experts are in the process of being recruited to serve as technical advisors to the BOG. The proposed technical assistance program is outlined in Annex 3-3 including the terms of reference of the banking supervision experts, whose assistance is critical to the success of strengthening the supervision function. Besides, increases in compensation are critical to attract and retain high quality individuals in the Bank Examination Department. Therefore, the BOG will, in line with the overall review of compensation for civil servants as part of the structural adjustment program, reassess staffing and compensation in conjunction with the possible reorganization of the department.

58. Prudential supervision of banks is also provided in the forms of external audits and financial disclosure. Audits of banks conducted in the past failed to disclose the extent of problems subsequently identified in the diagnostic studies. It is apparent that not only auditing standards must be strengthened but training of auditors must receive high priority. In this regard, the Institute of Chartered Accountants has an important role to play in providing leadership to the auditing profession in Ghana. A technical assistance program is envisaged for the training of auditors (Annex 3-5). The program also includes a component for a consultant to assist in developing auditing standards.

59. Financial disclosure can help to instill discipline. However, given the present state of the banking system generally, full financial disclosure is considered inappropriate at this time. Nonetheless, certain information, such as deposit account statements and schedules of charges, should be made available to the public. In this regard, the Banking Law Committee will establish standard patterns of information disclosure to the public.

D. Bank Restructuring

60. As stated in para 19, a large number of Ghanaian banks are facing severe financial difficulties, which are threatening their liquidity and solvency and thereby the stability of the financial system overall. This is

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particularly the case of the three development banks, but to a lesser extent also of some major commercial banks. This situation was attributable to inappropriate sector policies and regulations affecting the operation of the banks in the past, inadequate banking supervision by the authorities, internal weaknesses on the part of the banks themselves (in particular deficient management team and poor procedures and controls), as well as the massive devaluations in recent years which have considerably increased the corporate sector's indebtedness and reduced its capacity to service its debt to the banks, exacerbating the latter's portfolio arrears. The Government realizes the critical need to restore the financial health and operational capacity of the distressed Ghanaian banks. Comprehensive diagnostic studies by international auditing firms have been carried out for the three development banks and six major commercial banks to determine accurately their financial and operational condition and the appropriate remedial measures required. These audit reports constitute the first step in a review process which would determine for each bank its prospects for future viable operation and restructuring requirements. External audits under the aegis of BOG will be repeated for the coming two to three years until such a time as BOG's examination department has been satisfactorily strengthened.

61. The basic principles that are to govern the restructuring of the banks, have been agreed between the Government and IDA and are spelled out in the Statement of Financial Policy (Annex 4--paras 7 to 9), along with specific targets for restructuring plans (Implementation Schedule Section II - 4 to 7). The systematic review of audit reports by the Ghanaian authorities and IDA, will provide a basis for deciding on a future course of action (recapitalization/restructuring, merger, liquidation) for each bank. The eventual decision to recapitalize an individual bank will be based on a realistic assessment of this bank's prospects for viable operation within a reformed banking system more liberalized and competitive and with much reduced reliance on GOG/BOG funding and other concessional funding. This will entail a three-phased process of which the first step would be the preparation of detailed business projections for at least a 5-year period based on realistic assumptions of future operations. The iterative process by which these projections will be undertaken would involve consideration of fundamental issues such as sectoral specialization vs universal banking, the options of mergers and liquidations, degree of appropriate state financial support. Once satisfactory projections are obtained for an individual bank, a specific restructuring plan will be prepared for it, stipulating the arrangements (operational, financial, managerial, legal) for the bank's future operation. Monitorable steps for the implementation of the restructuring plan will be embodied in a performance contract to be signed between the Government/BOG and the bank setting out the respective obligations and commitments of each party. All restructuring plans for individual banks will be sent to IDA for review and agreement prior to their implementation.

62. In addition to immediate safeguard measures to be taken as necessary so as to arrest further financial deterioration (i.e., discontinuation/curtailment of new lending; concentration on loan recovery, reduction in operating costs; reconciliation of accounts), specific modalities will be worked out to settle the accumulated deficits involving an appropriate mix of cash injections and non-cash adjustments, in particular (i) rescheduling/conversion of external and GOG/BOG loans to banks; (ii) transfer to the Government of the banks' portfolio of non-performing loans to state-owned enterprises and/or those guaranteed by the Government. Beyond

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internal measures at the level of each individual bank, arrangements for loan recovery might include the transfer of the banks' non-performing loan portfolio to a separate entity (collection agency, managed fund, restructuring fund) or its sale at a discount.

63. Financial requirements for restructuring Ghanaian banks (both for resorbing the aggregate deficits of the whole banking system and for recapitalization of selected banks) can only be roughly estimated at this stage, pending the completion/analysis of their audits and the subsequent decision-making process leading to their recapitalization/restructuring. Initial estimates indicate that overall needs would approximate US$280 million. Of this amount about US$40 million could be met with the conversion into quasi-equity of loans from GOG/BOG and external lenders to the banks (principally the development banks) and US$20 million through the repurchase by GOG of non-performing loans to state enterprises. To monitor the proper implementation of the bank restructuring program, the Government is in the process of establishing a Technical Committee, reporting to the Financial Sector Adjustment Committee (para 77). Given the magnitude and complexity of the exercise, the project would finance a bank restructuring adviser for a period of 18 months, acting as special adviser to the Technical Committee, to be recruited by September 1988 (Annex 3-7).

E. Corporate Restructuring

64. As evidenced by the banks' audits available to date, a number of Ghanaian enterprises, particularly those with foreign debts/or depending largely on imported inputs, are in need of both physical and financial restructuring, in the aftermath of recent massive devaluations, high inflation rates, and adjustment policies (trade liberalization, reduction in effective protection). This situation warrants the consideration of a nationwide program for corporate restructuring, the basic objective of which would be to offer comprehensive financial packages linking future debt repayments to the cash-generation capacity of individual firms, using such instruments as debt/equity swaps, reschedulings of remaining debts over longer maturities, interest capitalization, partial write-off of accumulated penalty charges, and injection of fresh money for increased liquidity and new fixed assets. Significant managerial and operational restructuring would have to be considered as well. Restructuring will be selective and confined to those enterprises temporarily in financial distress but with clear medium-term prospects for profitable operation. The provision of technical assistance and expert guidance to the banks and the enterprises will be needed for the design as well as the implementation of restructuring proposals. Although the responsibility for enterprise restructuring should normally rest with the banks, the magnitude and complexity of the problem appear to require putting in place, at the country level, an institutional framework that would (a) generally oversee the implementation by the banking system of the nationwide enterprise restructuring program; (b) refinance a part of the restructuring credits/investments by the banks; and (c) provide the technical assistance required. The Government has requested IDA's assistance in initiating a study toward the design and establishment of a corporate restructuring program along the foregoing lines (Annex 3-8).

F. Rural Finance

65. The Government places a high priority on improving the efficiency of rural financial mechanisms to support economic, particularly agricultural,

activity in rural areas. Financial intermediation in rural areas requires, however, special treatment because of the informal nature of the financial intermediaries that operate there, and the reluctance of formal financial institutions to undertake high-cost high-risk intermediation activities in rural areas. The Government is therefore conducting two studies of the rural financial subsector with the support of IDA. The first will be a comprehensive study of the entire range of rural financial intermediation required for the rural population. The second will focus on a diagnosis of a sample of rural banks (ten to fifteen) to provide the basis for the BOG to formulate a program of action vis-a-vis these banks. These two studies together will be used to design a sector specific action program, to be supported by a forthcoming Rural Finance project, and which will be fully consistent with the thrust of the present financial sector adjustment program.

G. Foreign Exchange Risk

66. Exchange losses resulting from loans denominated in foreign currency account for a large share of the financial sector deficit (about US$100 million). Although exchange rate fluctuations comparable to those observed between 1983 and 1986 are less likely in the future as long as the Government pursues its liberalized trade and exchange rate policies combined with monetary and fiscal discipline, it would be advisable to consider a mechanism by which borrowers could be adequately protected against unexpected future variations of the exchange rate. To that end the BOG intends to study and develop a model to forecast the foreign exchange risk and determine an appropriate level for the fee that borrowers would have to pay to BOG in exchange for exchange risk protection. This study will be financed under the proposed project. Based on the study's findings, it is envisaged that a fund managed by BOG would be established to cover actual losses as needed. Seed funding would be provided by the Government.

IV. THE PROPOSED CREDIT

A. Origin and Objectives

67. The proposed credit has originated from the Bank's sector work initiated in Ghana since 1985. Critical to continued progress in the structural adjustment effort is the need to develop a well functioning and broadly based financial sector. To that end, the Government has designed a comprehensive and far-reaching action program with the following main objectives: (i) to enhance the soundness of banking institutions through reforms of the regulatory framework and the restructuring of distressed financial institutions; (ii) to improve deposit mobilization and efficiency in credit allocation; (iii) to develop money and capital markets. Significant steps have already been taken towards the implementation of this program: interest rates have been liberalized in September 1987 and February 1988, external audits undertaken for the nine major banks, two specialists in banking supervision have been recruited by the BOG and a study on improved standards for banks' accounting and reporting has been initiated recently. The credit would support the initial action program of policy and institutional reforms as set out in the Government's Statement of Financial Policy (Annex 4).

B. The Macroeconomic Context

68. The financial sector adjustment program is a key element of the Government's economy-wide structural adjustment program (see paras 5-11). The total external financing required to support the structural adjustment program during the period 1988-90 is projected to be about US$2,200 million (see Annex 1-3). The proposed financial sector adjustment credit of US$100 million will meet 4.5 percent of this external financing requirement. A large part of the remainder (US$1,300 million) has been identified from existing and expected commitments from bilateral and multilateral donors. The residual financing gap of about US$800 million is expected to be met by the IMF enhanced structural adjustment facility, IDA's contribution to the African debt initiative, and additional financing from cofinanciers.

C. Description

69. The IDA credit of US$100.0 million will be made to the Government at standard IDA terms with 40 years maturity. The credit would have a sector reform component and a technical assistance component.

1. Sector Reform Component

70. This component of US$95 million equivalent would be in support of ongoing and new policy and institutional reforms undertaken in the financial sector over the 1987-1990 period, as outlined by the Government in the Statement of Financial Policy, the major objectives of which are to:

(a) enhance the soundness of banking institutions through (i) a review of the legal framework, (ii) improved modalities for bank supervision, (iii) strengthening the training of bankers, (iv) strengthening the accounting and auditing professions, (v) support to the financial restructuring of the corporate sector.

(b) restructure financially distressed banks on the basis of full external audits, followed by a thorough review of each bank's prospects for future viability within a liberalized and competitive system (with much reduced reliance on GOG funding and other financial privileges), and restructuring needs therefor. The decision on a future course of action for each bank (recapitalization/restructuring, merger, liquidation), on the basis of this review, would lead to the preparation of a specific restructuring plan, the implementation of which would be monitored by a performance contract.

(c) improve resource mobilization and allocation through (i) measures aimed at further restoring public confidence in banks, (ii) liberalization of interest rates, bank charges and commissions and sectoral credit ceilings, (iii) development of money and capital markets through the rationalization and strengthening of the CDH and the introduction of policies and institutional vehicles for capital market development.

2. Technical Assistance Component

71. This component of US$5 million will finance (i) a comprehensive program of technical assistance to the BOG (Annex 3-3 and 3-4), (ii) training

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programs for the Institute of Chartered Accountants (Annex 3-5), (iii) training programs aimed at improving the profession of bankers (Annex 3-6), advisory services to the Technical Committee for Banking Restructuring (Annex 3-7), (iv) technical assistance to CDH (Annex 3-1), (v) an assessment of the potential for capital market development and related studies (Annex 3-2), (vi) a study to assess the need for corporate restructuring and the initiation of a pilot program (Annex 3-8), and (vii) a study on exchange risk protection (para 66). Costs of technical assistance and studies are summarized in Annex 3-9.

D. Procurement and Disbursement

1. Sector Reform Component

72. Procedures for procurement and disbursement would be largely patterned upon those applied for the recently approved SAC to Ghana. The proceeds of the proposed sector reform component (US$95 million equivalent) would be used exclusively for the financing of the foreign exchange cost of eligible imports through the foreign exchange auction in the BOG. Procurement procedures have been designed to permit rapid use of the funds while ensuring efficiency and economy. Except for a few exclusions such as luxury and defense items, any imports would be eligible for financing. Not more than SDR 20 million equivalent of the proceeds of the credit would be used for petroleum imports. In order to speed up disbursements, imports below US$2 million by private entities would be procured in accordance with their normal procedures; the Government and SOE procedures for imports below US$2 million equivalent would be acceptable to the Association. Imports worth US$2 million or more would be subject to international competitive bidding according to Bank Guidelines, using current standard bidding documents, which are acceptable to IDA. International suppliers are well represented in Ghana; this, together with the ongoing auction system and trade liberalization, should ensure an internationally competitive market in which importers can be relied on to procure their goods and services from the least costly and most reliable sources. 100 percent of the costs of technical assistance and studies would be financed under the project.

73. To facilitate procurement and disbursement, multiple special accounts (up to six), would be established in U.S. dollars at commercial banks, on terms and conditions acceptable to the Association. Initially, US$18 million of the IDA credit will be deposited in these special accounts. Applications for replenishment of the special accounts will be submitted monthly, or when withdrawals equal one-sixth of the amount advanced. Applications will be fully documented with respect to payments against contracts of more than US$500,000 equivalent. Reimbursements for payments against smaller contracts will be made on the basis of statements of expenditure certified by the BOG with supporting documents retained for review by visiting missions. Annual audit reports will include a separate audit of amounts withdrawn on the basis of statements of expenditure and on special accounts.

74. The proceeds of the proposed sector reform component would be disbursed in three tranches as follows:

(a) a first tranche of US$45 million equivalent (SDR 32.5 million) would become available immediately upon effectiveness (by August 1988);

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(b) a second tranche of US$30 million (SDR 21.6 million) would be made available following a review of performance, six months after effectiveness, that would determine that the reform program is being satisfactorily implemented and in particular that the conditions stipulated in para 77.2 have been fulfilled.

(c) a third tranche of US$20 million (SDR 18.0 million) would be made available following a review of performance, nine months after second tranche release that would determine that the conditions stipulated in para 77.3 have been fulfilled.

Conditions for tranche release are detailed below under section E "Monitorable Actions".

75. Cofinancing of US$140 million is being sought under this project. The Swiss Government has indicated at negotiations its intention to contribute to the cofinancing of this project in an amount of Swiss Francs 15 million while AfDB and the Japanese Government (OECF) are expected to contribute in amounts of US$50 million and US$55 to 70 million equivalent, respectively. The British and Canadian Governments have also been approached. On the basis of the reactions received so far from these sources, it is expected that the target amount for cofinancing will be achieved. It is intended, to the extent possible, that these cofinancing funds be tranched in such a way as to ensure balanced tranche disbursements.

2. Technical Assistance Component

76. Consultancy services for the various technical assistance subcomponents will be obtained as per the Bank's Guidelines for Recruitment of Consultants. Procurement of other items such as vehicle and office equipment will be as per the procurement procedure described in para 71 above. Disbursement under the technical assistance component will not be subject to the tranche release conditions. Statement of expenditures would be used for expenditures not exceeding US$50,000. A special account of US$1,000,000 representing about four month's expenditures would be established at a commercial bank to expedite disbursements. Audit requirements would be similar to those of the sector reform component (paras 72-73).

E. Monitorable Actions

77. The Statement of Financial Policy (Annex 4) describes the specific reform measures that have been or will be taken during this phase of the adjustment program. These measures are summarized in the Implementation Schedule attached to this Statement. A high level Financial Sector Adjustment Committee chaired by the Secretary for Finance and Economic Planning, with the Governor of the BOG as Vice-Chairman, and reporting to the Chairman, Committee of Secretaries will oversee the implementation of the program. Conditions for tranche releases are listed below.

1. Conditions for Effectiveness

(i) Agreement with IDA on amendments to the Banking Act and other relevant regulations covering prudential rules relating in particular to capital adequacy of banks, reserve requirements, exposure limits, penalties and reporting requirements to the BOG.

(ii) Agreement with IDA on a proposal setting out uniform auditing and accounting standards for banks.

2. Conditions for Second Tranche Release

(i) Satisfactory implementation of amendments to the Banking Act and other regulations referred to under para 77.2 (i).

(ii) Satisfactory monitoring by BOG of compliance by banks with uniform accounting and auditing standards.

(iii) Agreement with IDA on a timetable for a phased decontrol of banking charges.

(iv) Enactment of the amended Social Security Decree.

(v) Receipt of a Government Statement satisfactory to IDA specifying the modalities for the restructuring of banks and in particular (i) the restructuring/conversion of loans and deposits extended to banks by GOG/BOG and external lenders; (ii) measures for dealing with banks' portfolio of non-performing loans; and (iii) additional measures for dealing with non-performing loans to State Enterprises.

(vi) Agreement with IDA and implementation of a specific proposal for the reduction by at least 50% of doubtful loans and off-balance sheet items in the aggregate portfolio of banks.

(vii) Agreement with IDA on restructuring plans for banks accounting for at least 50% of commercial banks' assets and 50% of development banks' assets.

(viii) Preparation and implementation of an action program for the strengthening of CDH.

(ix) Completion of a study on the potential for capital market development and related requirements.

(x) Completion of a study on exchange risk protection.

3. Conditions for Third Tranche Release

(i) Review of the sectoral credit floor for agriculture in consultation with IDA and implementation of the resulting agreement.

(ii) Satisfactory implementation of the plan for the reduction of non-performing loans and off balance-sheet items in the portfolio of banks and of the banking restructuring plans agreed upon under paras 77.2 (vi) and (vii).

(iii) Agreement on a program for the residual portfolio of non-performing loans and off-balance sheet items and on restructuring plans for the remaining commercial and development banks.

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(iv) Satisfactory implementation of the recommendations of the study on the capital market (para 77.2 (ix)).

(v) Establishment of the Credit Clearing House.

F. Justification and Risks

1. Justification

78. An efficient, broadly based financial sector, with an effective banking system at its core, is necessary to provide the support for the continued structural adjustment effort. Ghana does not yet have this. The formal financial system is at an early stage of development and has been handicapped by significant institutional weaknesses, limited mobilization of financial resources and deficiencies in credit allocation, all of which have constrained the supply of credit to the productive sectors. The initial action program seeks to address these handicaps. It aims to strengthen the financial institutions, expand the scope of the formal financial system and improve the efficiency of financial intermediation in Ghana. Emphasis is placed on priority policy and institutional reforms necessary to overcome the key constraints or imperfections in the financial system which are hindering the flow of funds to the efficient productive sectors, thus limiting investment and production responses to the ongoing adjustments of trade and incentive policies. Increased efficiency of the financial sector will thus enhance growth, both by increasing savings and by channelling them to higher yielding investments. The enhanced soundness of the banking institutions, which will be pursued through their restructuring, and training programs for banks' employees, together with the proposed amendments to the Banking law and other relevant regulations, and the improvement in the supervision and surveillance of the banking system by the BOG will increase confidence in the banking system, thus inducing its further growth. The credit will also address the development of the money market and capital market, which together with an initial program aiming at restructuring the corporate sector should contribute both to a broadening of the financial system and stimulate private investment. In addition, the development of the profession of accounting and auditing, and improved accounting systems will in the long-run improve the Government's budgetary control, improve monitoring of state enterprises performance and tax collection. In the private sector, efforts at productivity improvement and restructuring will be facilitated.

2. Risks

79. The main risk relates to the inherent complexity of undertaking a sector-wide restructuring of the banking system which requires not only the strong commitment of the Ghanaian authorities but also the full cooperation of the banks' management. Other risks include the timely and adequate availability of resources, and the strain the project will place on the country's implementation capabilities. These risks are, however, mitigated by (a) the Government's commitment to undertake banking restructuring on a sound basis, in accordance with principles formulated in consultation with IDA, and to seek IDA's agreement on individual restructuring plans prior to their implementation; (b) the tranching of the credit, which would further ensure satisfactory progress in the implementation of the sector reform program overall, and of banking restructuring in particular; and (c) finally, the sector reforms contained in the Action Program, in particular the recent liberalization of interest rates and the proposed improvement of the

regulatory framework and strengthening of Central Bank supervisory functions, are expected to go a long way in ensuring the competitiveness, efficiency, and soundness of the banking system in the future.

V. BANK GROUP OPERATIONS

80. Until March 1983, when lending was resumed after an 18-month hiatus, the Bank Group's assistance to Ghana was oriented towards projects with a strong emphasis on export promotion and rehabilitation of basic infrastructure. But the acuteness of the economic crisis of the past several years and the magnitude of structural distortions led the Government to develop a program of far-reaching economic reform which it announced in April 1983. This resulted in a major shift in the Bank's strategy. The main elements of this strategy are:

(a) to assist the Government, through the Bank's economic and sector work, supported where appropriate through technical assistance and program lending, to improve incentives for production, to increase the efficiency of economic management, and to restore in the medium term a sound financial basis for growth;

(b) to promote the long-term growth and development of the economy by underpinning structural adjustment lending with infrastructure rehabilitation and sector adjustment operations within a framework of appropriate sectoral policies, the latter encompassing industry and education; and

(c) to contribute to improved aid effectiveness in Ghana by acting as the focal point for aid coordination between donors and Ghana as the Government strengthens its own planning and aid coordination ability.

81. Based on the strategy outlined above, the Bank is supporting changes in incentive policies and improvements in economic management through a series of program credits designed to provide critically needed imports, particularly to export sectors and supporting economic infrastructure such as transportation. The latest in this series of credits is the Structural Adjustment Credit approved in April 1987. The Bank supplemented this with a Structural Adjustment Institutional Support Project to support and strengthen the implementation agencies involved in the structural adjustment program. All program credits taken together amount to 57.1% of total commitments. To prepare for these credits, the Bank carried out a public expenditure review, an agricultural sector review, an industrial sector study and an assessment of issues and options in the energy sector, supervised cocoa sector studies under an ongoing project, and acted as Executing Agency for a UNDP-financed study of the public enterprise sector. In addition, an economic memorandum (Report No. 6635-GH, dated March 30, 1987) was prepared and used as a background document at the last Consultative Group meeting in May 1987.

82. Over the medium term, IDA lending will include a second structural adjustment operation, sector operations, and complementary project lending. Future project lending will concentrate on infrastructural rehabilitation, and focus on sectoral strategies, a sound policy framework, investment programs, public sector reforms, and institutional improvements.

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VI. COLLABORATION WITH THE IMF

1. Fund Relations with Ghana

83. Since the inception of the ERP, the Fund's Executive Board has approved three successive stand-by arrangements and two Compensatory Financing Facility purchases by Ghana resulting in a total use of Fund credit by end December 1986 of SDR 611 million or 299 percent of quota. The third stand-by arrangement equivalent to SDR 81.8 million (40 percent of quota) was approved on October 15, 1986. On November 6, 1987, the IMF Board approved the request by GOG for a three-year extended arrangement (SDR 245.5 million) and a three-year structural adjustment arrangement (SDR 129.9 million).

2. Bank-Fund Collaboration

84. Collaboration between the Bank and Fund staff has been good, both in the field, where there have been parallel and joint missions, and where the Bank's Resident Mission is in close touch with the Fund Resident Representative, and at headquarters, where there are frequent consultations. The staff of the two institutions have worked extremely closely with the authorities in designing the structural adjustment program. The Fund staff have focused in particular on exchange and trade policy, fiscal and domestic resource mobilization issues, and external debt management, while the Bank staff have focused on incentive policies including cocoa policy and trade liberalization, and public sector reform, including public expenditure policy, state enterprise reform, and public sector management. A Policy Framework Paper prepared jointly by the Government, the Bank, and the Fund, provided the framework for Ghana's recourse to the Extended Arrangement and the Structural Adjustment Facility approved by the Fund Board in November 1987.

VII. RECOMMENDATION

85. I am satisfied that the proposed Development Credit would comply with the Articles of Agreement of the Association.

86. I recommend that the Executive Directors approve the proposed Development Credit.

Barber Conable
President

Attachments

Washington, DC
May 9, 1988

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ANNEX 1-1

GHANA

FINANCIAL SECTOR ADJUSTMENT CREDIT

KEY ECONOMIC INDICATORS

	Actual		Prelim.		Projected		
	1984	1985	1986	1987	1988	1989	1990
	(in %)						
GDP Growth Rate	8.6	5.1	5.3	4.5	5.5	5.0	5.0
GDY Growth Rate a/	5.6	4.2	6.1	4.5	5.5	5.0	5.0
GDY/Capita Growth Rate a/	2.3	0.9	2.8	1.2	2.2	1.7	1.7
Total Consump./Capita Growth Rate	-	0.0	1.1	-0.6	0.4	1.0	1.0
Debt Service, MLT (in US$ M) b/	403	415	386	567	561	464	376
Debt Service/XGS c/	59.7	59.2	44.6	60.5	56.1	41.8	30.1
Debt Service/GDP	5.4	6.1	8.0	12.3	11.3	8.8	6.4
Gross Investment/GDP	6.9	8.0	10.7	13.0	15.0	16.9	18.0
Domestic Savings/GDP	4.1	5.2	7.2	9.9	11.5	11.7	11.8
National Savings/GDP	4.0	4.1	6.5	8.2	10.3	11.2	12.0
Marginal National Savings Rate	-	40.0	32.8	45.8	39.3	23.0	22.5
Public Investment/GDP	2.5	3.8	5.9	7.9	7.8	8.2	8.4
Public Savings/GDP	-0.6	0.1	1.7	3.2	2.8	3.4	3.6
Private Investment/GDP	4.4	4.2	4.8	5.1	7.2	8.7	9.6
Private Savings/GDP	4.6	4.1	4.7	5.0	7.5	7.8	8.3
Ratio of Public/Private Invest.	0.56	0.92	1.21	1.57	1.09	0.94	0.87
Government Revenues/GDP	8.0	10.4	13.6	14.0	13.5	14.0	14.0
Government Expenditures/GDP	10.9	14.1	17.8	19.1	18.9	19.1	18.9
Deficit (-) or Surplus (+)/GDP	-2.9	-3.7	-4.2	-5.1	-5.4	-5.1	-4.9
Export Growth Rate	-	22.4	12.3	8.7	9.1	4.6	5.4
Export/GDP	8.0	9.8	16.6	19.3	19.1	19.0	18.4
Import Growth Rate	-	8.8	13.0	2.4	5.6	12.0	9.3
Imports/GDP	10.7	12.5	20.1	22.4	22.5	24.2	24.5
Current Account (in US$M)	-214	-263	-203	-220	-231	-299	-356
Current Account/GDP	-2.8	-3.8	-4.2	-4.8	-4.6	-5.6	-6.0

Source: World Bank Estimates.

a/ GDY per capita = GDP per capita adjusted for changes in the terms of trade.
b/ Includes IMF and payments of arrears but excludes repayments of short-term oil facility borrowings.
c/ Includes private unrequited transfers.

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GHANA

FINANCIAL SECTOR ADJUSTMENT CREDIT

BALANCE OF PAYMENTS

(US$ million)

	1986	1987	1988	1989	1990
Exports of Goods (fob)	749	787	840	897	973
Cocoa bean and products	503	465	448	459	480
Other exports	245	322	392	439	493
Imports of Goods (cif)	-791	-836	-915	-1,069	-1,223
Oil	-125	-144	-162	-166	-176
Non-oil	-666	-692	-754	-903	-1,047
Trade Balance	-42	-50	-75	-172	-250
Non-factor Services	-127	-92	-98	-107	-107
Receipts	48	102	109	115	114
Payments	-175	-194	-208	-222	-221
Resource Balance	-169	-141	-173	-279	-357
Net Factor Payments	-106	-132	-113	-100	-87
Interest Payments	-102	-127	-110	-98	-90
Public	-45	-73	-55	-56	-57
Private	-1	-2	-6	-8	-8
Banking	-55	-52	-48	-35	-25
Factor Payments & Other	-4	-5	-3	-2	3
Net Private Transfers & sul	72	53	56	80	88
Current Account Balance = Foreign Savings	-203	-220	-231	-299	-356
As % of GNP	-4.3	-4.9	-4.7	-5.7	-6.1
External Capital Inflow	183	380	290	277	284
Grants	118	123	149	143	141
Public Foreign Borrowings	113	210	123	111	135
MLT net	124	223	137	122	138
Gross Inflows	372	405	286	267	282
Concessional (LT)	257	290	250	230	249
of which: SALs	0	58	88	56	43
Non-concessional (MT)	115	115	36	37	33
of which: oil	59	64	0	0	0
Amortization	-248	-182	-149	-145	-144
Trust Fund	-11	-12	-13	-12	-4
Private Foreign Borrowing (Net)	-3	9	2	-0	
Direct P[illegible] Investment	4	5	6	7	8
[illegible]	-71	-45	2	16	0
[illegible]	-38	-21	0	0	0
Overall Balance	-58	139	59	-22	-72

Source: World Bank Estimates.

ANNEX 1-3

GHANA

EXTERNAL FINANCING REQUIREMENTS
(millions of US$)

	1988	1989	1990
I. Requirements	761.0	743.0	696.7
Current Account Deficit (excl. official transfers)	231.0	299.0	356.0
-of which Interest payments on official debt a/	104.0	90.0	82.0
Amortization b/	162.0	157.0	148.0
Repayments to the IMF (Repurchases)	265.0	182.0	112.0
Increase in Reserves	35.0	39.0	38.0
Reductions in debt arrears	30.0	35.0	33.7
Other c/	38.0	31.0	9.0
IIa. Disbursements: Existing Commitments d/	204.0	143.0	88.0
Official Grants	71.0	43.0	24.0
Public MLT Loans	118.0	92.0	64.0
Bilateral	22.0	25.0	25.0
Multilateral	96.0	67.0	39.0
Project-related	96.0	67.0	39.0
SAL and cofinancing	-	-	-
Other	-	-	-
SAF	-	-	-
IMF disbursements	-	-	-
Private Creditors	15.0	8.0	0.0
Direct Foreign Investments	-	-	-
IIb. Disbursements: Expected New Commitments	346.9	276.2	343.2
Official Grants	78.0	100.0	117.0
Public MLT Loans	131.6	138.2	185.2
Bilateral	25.0	24.0	58.0
Multilateral	106.6	114.2	127.2
Project-related	18.5	58.0	84.0
SAL and cofinancing	88.1	56.2	43.2
Other	-	-	-
IMF disbursements	101.3	0.0	0.0
Private Creditors e/	30.0	31.0	33.0
Direct Foreign Investments	6.0	7.0	8.0
II. Total Identified Financing	550.9	419.2	431.2
III. Residual Financing Gaps before Rescheduling	210.1	323.8	265.5
IV. Debt Relief (expected rescheduling)	0.0	0.0	0.0
V. Residual Financing Gaps after Rescheduling (III - IV)	210.1	323.8	265.5
VI. Possible Sources	210.1	323.8	265.5
ESAF	113.7	131.7	154.4
IDA	8.4	30.3	23.3
Cofinanciers	88.0	161.8	87.9

Note: Possible sources of additional funds to fi[illegible] above table have been identified in the conte[illegible]

a/ Includes IMF charges.
b/ Includes IMF Trust Fund but excludes outflows for Government's purchases of petroleum.
c/ Includes outward official unrequited transfers.
d/ As of December 31, 1986.
e/ Excludes commercial financing of Government's purchases of petroleum.

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FINANCIAL SECTOR ADJUSTMENT CREDIT

ASSETS AND LIABILITIES OF BANKS

(In million cedis at end period)

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987 (Sept.)
Cash on Hand	39.6	54.1	106.7	212.1	196.8	409.4	461.0	700.7	1,401.1	2,304.3	3,421.8	3,581.6	7,288.6
Balance with BOG and Other Banks	267.0	504.1	610.5	1,368.6	1,788.8	1,965.0	1,902.9	3,421.7	4,424.3	6,514.3	18,722.1	24,604.0	29,689.5
Treasury Bills, Stocks and Bonds	216.8	341.5	570.5	764.0	1,111.8	1,689.0	2,300.0	4,288.7	6,887.0	8,289.8	8,634.2	11,581.1	10,764.0
Commercial Bills	118.2	155.0	189.4	302.3	354.8	35.0	41.1	489.2	402.1	40.2	2,071.7	1,664.5	445.8
Loans and Advances	804.1	770.9	1,097.9	1,543.5	1,749.0	2,882.0	3,169.4	3,878.5	5,423.4	12,260.0	22,498.6	40,986.5	52,986.5
Other Assets d/	248.2	289.9	449.7	886.4	1,806.8	1,498.9	2,356.8	5,368.8	8,477.2	16,284.9	18,348.6	20,811.5	57,987.7
Total Assets	1,584.2	2,116.3	3,129.9	5,166.9	6,891.0	7,974.1	10,226.1	18,072.4	27,655.9	41,780.8	64,711.0	112,899.8	156,962.8
Demand Deposits b/	500.9	688.9	1,287.7	2,596.1	2,514.5	3,019.0	3,263.6	5,749.0	6,719.9	12,286.9	21,671.2	28,980.4	35,982.6
Saving Deposits	204.0	488.8	800.8	1,689.5	1,287.9	2,184.0	2,711.3	4,369.8	4,902.1	6,996.0	8,882.2	14,140.6	18,616.2
Time Deposits	188.6	185.5	189.9	248.9	268.8	315.0	388.7	460.7	570.8	1,189.6	2,642.5	5,688.6	13,688.5
Balance with BOG and Other Banks c/	91.4	188.5	117.0	165.8	198.8	373.4	291.3	367.8	1,772.9	3,072.5	8,285.1	11,586.4	26,210.7
Paid-up Capital and Reserves	118.1	147.4	189.5	375.7	288.8	489.0	440.8	688.9	2,611.5	4,396.1	8,588.6	7,386.5	8,408.4
Other Liabilities d/	318.2	449.4	848.8	1,081.6	1,298.8	1,779.7	3,181.8	6,108.7	8,936.2	13,614.8	19,388.8	40,398.8	58,981.4
Total Liabilities	1,584.2	2,116.3	3,129.9	5,166.9	6,891.0	7,974.1	10,226.1	18,072.4	27,655.9	41,780.8	64,711.0	112,899.8	156,962.8

Source: Bank of Ghana, World Bank.

a/ Excludes BOG.

b/ Includes all government deposits.

c/ Includes external borrowings of banks.

d/ Other assets include fixed assets, other real assets, special deposits with BOG, miscellaneous, etc., other liabilities include margins against contingency liabilities, balance in transit, some borrowings from local banks, and miscellaneous, etc.

Note: The proportion of public sector deposits plus government deposits over total deposits is about 80% for 1985, 16% for 1986, and 18.8% as of September 1987.

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GHANA

FINANCIAL SECTOR ADJUSTMENT CREDIT

GDP/MONEY SUPPLY

	1970	1975	1980	1981	1982	1983	1984	1985	1986	1987 (estimate)
In million cedis or percentages										
Total GDP at current market prices	2,250	5,203	42,853	72,626	86,451	184,836	276,561	373,868	511,256	782,789
Banking system net assets (1)	572.7	1,745.8	9,862.2	15,393	19,938	26,146.7	33,129.2	48,591.4	67,897	96.129
Assets/GDP	0.25	0.33	0.23	0.21	0.23	0.15	0.12	0.13	0.13	0.14
Total Bank Credits			2,067.8	2,882.7	2,986.1	5,732.1	11,096.7	21,461.1	46,328.6	73,945
Credits/GDP			0.05	0.04	0.03	0.03	0.04	0.06	0.09	0.10
Total Narrow Money Supply (M1)	385.4	1,069.8	6,224.6	10,147.6	12,297.1	18,776.1	26,643.3	43,471.1	64,619.6	186,636
M1/GDP	0.14	0.19	0.15	0.14	0.14	0.10	0.10	0.12	0.13	0.14
Total Broad Money Supply (M2)	426.6	1,386.3	8,696.2	13,634	17,129.6	24,323.5	33,835.9	55,836.1	84,684	113,782
M2/GDP	0.19	0.26	0.20	0.19	0.20	0.13	0.13	0.15	0.17	0.19

Source: BOG and World Bank Estimates

(1) Includes Bank of Ghana.

MONEY SUPPLY

	1970	1975	1980	1981	1982	1983	1984	1985	1986	1987 (Sept.)
Million Cedis Currency										
Notes & coins in circulation	167.1	524.4	3,897	6,552	7,488.3	11,434.8	16,234.4	25,326.5	34,734.7	46,357.6
Held by commercial banks	18.4 *	38.8 *	469.4	666.9	766.7	1,396.2	2,291.2	3,429.8	3,494.5	7,638.8
Total held outside banks	148.7	485.6	3,427.6	5,945.1	6,727.6	10,038.6	13,943.2	21,896.9	31,240.2	38,318.8
Demand deposits										
With Primary Banks	154.7	523.2	2,898	3,389.8	4,848	5,477	8,778.1	13,246.1	17,734.1	19,826.6
With Secondary Banks	NA	NA	851.3	864.4	1,419.1	2,717.2	3,786.1	7,549.6	13,666.8	16,267
With Bank of Ghana	NA	NA	55.7	28.3	162.4	539.3	186.9	784.5	2,634.5	7,276.2
Total demand deposits	154.7	523.2	2,797	4,292.5	5,569.5	8,733.5	12,766.1	21,514.2	33,379.4	43,368.8
Total narrow money supply (M1)	385.4	1,069.8	6,224.6	10,147.6	12,297.1	18,776.1	26,643.3	43,471.1	64,619.6	76,687.6
Time & Savings Deposits:										
With Primary Banks	121.2	377.5	1,881.6	2,613.5	3,632.5	4,684.2	5,167.8	8,465.2	13,951.5	19,982.6
With Secondary Banks	NA	NA	816	872.9	1,200	1,469.2	2,084.8	3,159.8	6,032.9	11,220.5
Total Quasi Money	121.2	377.5	2,471.6	3,486.4	4,832.5	5,553.4	7,192.6	11,565	19,984.4	31,123.1
Total Broad Money Supply (M2)	426.6	1,386.3	8,696.2	13,634	17,129.6	24,323.5	33,835.9	55,036.1	84,684	107,816.7

*Primary Banks only.

Source: Bank of Ghana

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FINANCIAL SECTOR ADJUSTMENT CREDIT

DEPOSITS AND THEIR STRUCTURE

	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	(Sept.) 1987
(In million cedis)												
Demand Deposits	765.2	1,294.7	2,200	2,334.5	2,777.3	2,958.8	5,476.1	8,166.4	12,635.6	20,881.8	31,618.4	34,419.5
Savings Deposits	400.6	606.8	1,029.5	1,367.9	2,134	2,711.3	4,369.8	4,992.1	5,900	8,832.2	14,148.8	17,816.2
Time Deposits	186.5	189.9	242.9	268.2	315	380.7	466.7	578.3	1,186.8	2,842.6	5,986.6	13,989.5
Total	1,352.3	2,091.4	3,488.4	3,965.6	5,226.3	6,050.8	10,306.6	13,722.8	19,815.4	32,556.5	51,751.8	66,134.2
(In percentages)												
Demand Deposits	56	62	63	59	53	49	53	59	64	64	61	52
Savings Deposits	30	29	30	34	41	45	42	36	30	27	27	27
Time Deposits	14	9	7	7	6	6	4	4	6	9	12	21
Total	100	100	100	100	100	100	100	100	100	100	100	100

Source: Bank of Ghana

Note: Includes primary and secondary banks; and for both private and public sector.

GHANA

FINANCIAL SECTOR ADJUSTMENT CREDIT

TOTAL BANK CREDIT TO PRIVATE SECTOR AND PUBLIC ENTERPRISES BY SECTOR
(in million cedis)

	1980	1981	1982	1983	1984	1985	1986	(Sept.) 1987
Agriculture, forestry, fishing	412.4	655.0	688.6	2,012.9	3,779.1	5,207.6	7,476.3	9,447.1
Export trade	69.4	172.9	67.2	92.0	187.4	490.0	1.451.2	2,255.6
Manufacturing	472.0	508.3	635.2	866.6	3,288.4	6,046.4	10,800.4	15,952.5
Transport, storage, communications	193.5	215.2	201.8	331.3	653.7	1,154.3	2,021.5	3,451.2
Mining, quarrying	55.0	137.1	243.0	416.3	497.5	960.2	1,437.3	2,430.5
Import trade	34.4	47.6	42.4	107.4	307.7	990.7	2,931.4	4,476.4
Construction	289.1	411.9	511.2	796.6	1,273.9	2,017.8	3,899.4	5,052.9
Commerce and finance	246.0	321.1	293.5	683.2	1,175.0	2,820.3	5,042.0	5,265.7
Electricity, gas, water	116.0	44.2	42.2	49.6	21.4	37.8	46.1	83.8
Services	108.5	157.1	175.0	250.8	533.7	1,224.8	2,611.5	3,449.3
Miscellaneous	71.5	132.3	86.0	125.4	277.9	451.2	2,611.5	1,144.1
TOTAL	2,067.8	2,802.7	2,986.1	5,732.1	11,995.7	22,401.1	40,328.6	53,009.1

Source: Bank of Ghana

GHANA

FINANCIAL SECTOR ADJUSTMENT CREDIT

STUDY OF MEASURES NEEDED TO ENHANCE THE MONEY MARKET

1. An expert should be engaged to carry out an urgent assessment of the measures necessary to establish a proper operational and regulatory framework for the newly-opened Ghanaian money market. The expert should be, or have been until recently, a senior practitioner in a discount house or similar money market institution, preferably in a market similar to that in the UK. He will be fully familiar with the operations of a discount house, and will understand well the range of potential instruments in which it can deal. He should be accustomed to being involved in the formal and informal relationships which bind together the various participants in a money market, and particularly those between a discount house and the Central Bank. His standing and seniority should be such that his advice delivered in Accra, after a short visit, should be authoritative and self-evidently neutral and objective. For this reason, he should, desirably, be fully committed elsewhere, and unavailable for any longer term engagement in connection with the Ghanaian money market.

Terms of Reference

2. The expert will review all the available papers concerning the background of the Ghanaian money market, and the formation and operation of Consolidated Discount House Ltd. (CDH), including any money market regulations by then promulgated by the Bank of Ghana (BOG).

3. During a field visit to Accra of no more than two weeks, the expert will visit all institutions involved in the money market, for discussions on their expectations, and the degree to which these have been met since the opening of the money market on 30 November, 1987.

4. The expert will hold detailed meetings with officials involved at BOG, and have a dialogue on BOG's concerns in connections with the prudential regulation of CDH and the money market generally. This may or may not be in the context of extant regulations, but should also take cognizance of BOG's monetary control responsibilities.

5. Through extensive discussions with management and staff of CDH, the expert will form a view of the operational scope for a discount house in the Ghanaian environment, and the degree to which it is prospectively able to provide a useful and reasonably profitable service to its clients in the money market. This must include an in-depth assessment of the adequacy of the financial support and regulatory arrangements between CDH and BOG.

6. The expert will tender advice to CDH on the ambit and content of its Statement of Operational Policies, noting the extent of any differences existing on it between CDH and BOG.

7. Having performed the tasks described in 1-6. above, the expert will prepare a presentation which identifies all the significant issues requiring attention, to establish and maintain a soundly-based money market. It will go on to present unaquivocal recommendations. with justification where appropriate, as to how each of these issues should be resolved.

8. The presentation referred to in 7. above will first be made to BOG officials, who will be invited to make observations. These will be considered by the expert, who, in his discretion, may modify the contents of the presentation, before subsequently delivering it to the management of CDH. This latter audience may be widened, if considered appropriate by the expert, to include representatives of other financial institutions.

9. On return to base, the expert will write a confidential report, outlining the presentation as originally prepared, the BOG observations, the resultant changes, if any, and the germane comments by CDH or other recipients.

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FINANCIAL SECTOR ADJUSTMENT CREDIT

STUDY OF POTENTIAL FOR A STOCK MARKET

1. An expert on stockmarkets in developing countries should be engaged, to perform a study of certain aspects applicable to the introduction of a Stockmarket in Ghana, as detailed in the TOR's below. The expert should be particularly familiar with assessing the demand for the services to be offered through such a Stockmarket, from private investors, institutional investors and corporate issuers. The expert should be able to comment on the need for, and likely encouraging effect of, a variety of investment and issuing incentives. Knowledge of the workings of an exchange, and the influences on its profitability, are more important than expertise on legal frameworks or regulatory arrangements, which have been dealt with by others.

Terms of Reference

2. The expert should review the available reports on the background to, and implementation programme for the establishment of a Stockmarket in Ghana.

3. During a field visit to Accra of at least two weeks, the expert should meet the Government and Bank of Ghana officials responsible for the Stockmarket implementation plan, to understand more clearly their viewpoints, and expectations.

4. The expert should interview members of the Technical Sub-committee of the Committee on the Establishment of a Stock Exchange, and fully brief himself on the status of its draft plan.

5. A comprehensive study should be made of the prospective demand by investment institutions to purchase equity investments, and the likely use such institutions would make of the proposed Stockmarket in the initial purchase of such instruments, and subsequent trading. The study should cover, inter alia, commercial, merchant, development and specialized banks, insurance companies, pension and provident funds, the Social Security National Investment Trust and the National Trust Holding Company.

6. As much data as possible should be assembled on the use likely to be made of the proposed Stockmarket by individual and corporate investors, in both initial purchases and secondary trading.

7. An assessment should be made, based on management and shareholder interviews with a meaningful sample of private companies, of the likely use of the proposed Stockmarket by such enterprises in raising capital.

8. The expert should consider what types, if any, of incentive measures might enhance significantly the flow of investment funds and potential corporate issuers to the Stockmarket. He should determine the

likely and indirect effects of the proposed incentives, and provide a condensed statement of recommendation for transmission to the Ghanaian Authorities.

9. The expert should familiarize himself with the Government's latest privatization plans, and make appropriate enquiries about the suitability of using the facilities of the proposed Stockmarket for such divestitures.

10. Based on the results of his investigations, the expert should ascertain the likely profitability of the Stockmarket institutions, and form an opinion on the adequacy of the proposed institutional and administrative arrangements.

11. In the course of his work, the expert may well discover facts, or draw conclusions, which may be of relevance to the establishment of the Ghanaian Stockmarket, even though being peripheral to the main body of these TORs. These should be recorded separately, in an Annex to the report required under 12. below.

12. The results of the expert's work should be embodied in a full but concise report, covering all of his investigations and conclusions, for which two weeks preparation time should be sufficient. For the avoidance of doubt, it is required that the report contains his clear opinion on the prospects of an adequate quantum of business becoming available to the proposed Stockmarket, within a stated timeframe.

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GHANA

FINANCIAL SECTOR ADJUSTMENT CREDIT

TECHNICAL ASSISTANCE PROGRAM

FOR

THE BANK OF GHANA

1. Background

A strong system of bank supervision and a sound legal framework are necessary for the BOG to effectively carry out its role of monitoring and preserving the health of the financial system. Shortcomings in the existing legal framework and weak banking supervision have led to serious problems in the banking sector. Both prudential regulation and banking supervision must be improved if the BOG is to ensure the safety and soundness of a restructured banking system. This technical assistance program seeks to meet many of the needs for specialized expertise and technology necessary to strengthen prudential regulation and supervision including the:

(i) establishment of uniform accounting and auditing standards;

(ii) improvement in skill levels and examination methodologies of supervision staff;

(iii) strengthening of prudential reporting and development of an offsite analysis/early warning capability; and

(iv) revision of banking laws, rules, and regulations.

2. Concept for Technical Assistance

There should be several components to assist the BOG in strengthening prudential supervision and the legal framework. The components are:

(i) appointment of two bank supervision experts as long-term technical advisors;

(ii) training for bank supervision staff;

(iii) provision to employ a major international accounting firm for short-term assignments;

(iv) provision to employ a banking law expert for short-term technical assistance;

(v) provision to employ a technology consultant for short-term technical assistance; and

(vi) microcomputers and peripherals.

2.1 Bank Supervision Advisors

To strengthen bank supervision, specialized expertise is needed from abroad. Two advisors should be appointed for two year assignments to work closely with the BOG's Bank Examination Department. These advisors should be experts in bank supervision as demonstrated by their experience and standing in their home countries. At least one of the advisors should have experience at a senior level. Since they will be heavily involved in training, prior training experience and excellent communication skills are also desirable. It is anticipated that the advisors will have direct access and report to the Governor of the BOG. The primary functions of these advisors will be to:

(i) coordinate and conduct training of bank supervision staff and develop a permanent program for continuing examiner education;

(ii) develop and implement new concepts of bank supervision which focus on assessing the quality of management, asset quality, capital adequacy, earnings and efficiency, and liquidity/asset and liability management. The methodology should also be prospective in scope and should attempt to upgrade the quality of each bank's management systems as the first line of defense against imprudent and/or illegal practices. The new concepts of bank supervision should be formalized in written form in a manual of examination procedure;

(iii) improve prudential reporting and develop an offsite analysis/early warning capability;

(iv) establish uniform accounting and auditing standards;

(v) review organization, staffing, and compensation of the supervision unit and make appropriate recommendations;

(vi) develop mechanisms for handling distressed or failed banks and assist in the restructuring of banks; and

(vii) assist in such other matters as relate to banking supervision and the framework of banking laws, rules, and regulations.

These advisors should be selected and brought on-board as soon as possible. However, given the critical role they will play in the successful strengthening of the bank supervision function, considerable care should be taken in their selection.

2.2 Bank Supervision Training

In most countries, it takes four to five years, at a minimum, for an examiner to acquire the skills necessary to lead an examination team into a bank as the examiner-in-charge. To acquire these skills, a combination of on-the-job training, classroom instruction, seminars, and reference materials is needed. Therefore, a program is recommended which combines these features:

(i) a program of continuous education for examiners. The most critical skills in need of improvement are the following: (a) credit assessment and classification; (b) financial analysis; (c) asset and liability management; and (d) foreign exchange management;

(ii) fellowships for three senior examiners to travel abroad each year to participate in courses or seminars conducted by other bank regulatory agencies;

(iii) provision for two foreign experts to participate as instructors in two seminars to be held locally each year; and

(iv) provision for the purchase of books, instructional aids, and other materials necessary for training or reference.

2.3 International Auditing Firm

Uniform accounting and auditing standards should be introduced to eliminate existing accounting practices which understate problem assets, inflate income, and present a distorted picture of a bank's true condition. Uniform standards will also enable banking supervisors, investors, depositors, and creditors to compare the performance of institutions with a more reasonable degree of accuracy and comfort. To assist and expedite this process, it may be necessary to contract the services of a major international accounting firm. This firm will also be expected to assist in developing the prudential reporting formats necessary for bank supervisors to conduct offsite and early warning analysis. Therefore, a technical assistance component is included for two persons for three months during 1988.

2.4 Banking Law Expert

The BOG, together with the Ministry of Finance and Economic Planning, is proposing revisions to the existing body of laws, rules, and regulations which govern the conduct of banking. The proposed revisions seek to strengthen the hand of banking supervisors and correct omissions in the current law. For this reason, it may be necessary to review the legal framework as it exists in other countries and to consult the advice of an expert in the field. Therefore, a technical assistance component of has been allocated to support a one week visit during 1988 by an expert in the field of banking law and regulation.

2.5 **Technology Consultant**

The BOG will be establishing an offsite analysis/early warning function in its Bank Examination Department. This requires a short-term consultant to help select the appropriate hardware, program the application software, and train bank supervision staff in the basics of using and maintaining the system. The consultant will be required to work closely with the technical advisors for bank supervision to establish standard output reports. However, the system should remain flexible enough to manipulate data, prepare ad hoc reports, perform financial modeling, and permit revisions to the standard reports. The estimated need is for one consultant for approximately three months in 1988.

2.6 **Microcomputer Component**

The Bank Examination Department of the BOG requires three microcomputers, peripheral equipment, and software for its offsite analysis function.

3. **Technical Assistance Program Cost Estimates**

3.1 **Capital Expenditures**

(i) The cost for microcomputers, peripheral equipment, and software for the offsite analysis/early warning function is estimated at $30,000.

(ii) The cost of books, reference materials, instructional aids, and other materials for training during 1988 and 1989 is estimated at $10,000.

3.2 **Recurrent Expenditures**

(i) The cost of salaries and benefits, relocation and settling in expenses, housing, and amenities for two bank supervision advisors for a period of two years is estimated at $400,000 and 12,000,000 cedis.

(ii) Travel, subsistence, and enrollment expenses for three senior examiners to attend seminars abroad each year during 1988 and 1989 is estimated at $50,000.

(iii) Salary, travel, and subsistence expenses for two foreign experts to instruct at two seminars in Ghana each year are estimated at $70,000 and 320,000 cedis.

(iv) The cost of contracting two individuals from a major international accounting firm for a period of three months in 1988 is estimated at $250,000.

(v) Salary, travel, and subsistence expenses for a banking

law expert to visit Ghana for one week during 1988 is estimated at US$7,000 and 120,000 cedis.

(vi) Salary, travel, and subsistence expenses for a technology consultant for three months during 1988 is estimated at US$35,000 and 1,800,000 cedis.

BUDGET FOR BANK OF GHANA TECHNICAL ASSISTANCE PROGRAM

	1988			1989			Total		
	Man Months	Foreign $	Local cedis	Man Months	Foreign $	Local Cedis	Man Months	Foreign $	Local Cedis
A. Capital Expenditures									
Microcomputers		15,000						15,000	
Peripheral Equipment		6,000						6,000	
Software		6,000						6,000	
Other		3,000						3,000	
Books, reference materials, instructional aids, etc.		5,000			5,000			10,000	
TOTAL CAPITAL EXPENDITURES		35,000			5,000			40,000	
B. Recurrent Expenditures									
Bank Supervision Advisors	24			24			48		
Salaries		120,000			120,000			240,000	
Benefits		30,000			30,000			30,000	
Relocation/Settling In		50,000			50,000			100,000	
Housing and Amenities	—	—	6,000,000	—	—	6,000,000	—	—	12,000,000
	24	200,000	6,000,000	24	200,000	6,000,000	48	400,000	12,000,000
Seminars Abroad	2			2			4		
Fees		3,000			3,000			6,000	
Travel		12,000			12,000			24,000	
Subsistence	—	10,000	—	—	10,000	—	—	20,000	—
	2	25,000	0	2	25,000	0	4	50,000	—
Foreign Instructors	2								
Salaries		20,000			20,000			40,000	
Travel		15,000			15,000			30,000	
Subsistence	—	—	180,000	—	—	180,000	—	—	360,000
	2	35,000	180,000	2	35,000	180,000	4	70,000	360,000

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BUDGET FOR BANK OF GHANA TECHNICAL ASSISTANCE PROGRAM

	1988			1989			Total		
	Man Months	Foreign $	Local cedis	Man Months	Foreign $	Local Cedis	Man Months	Foreign $	Local Cedis
International Accountants									
Contract	—	250,000	—	—	—	—	—	250,000	—
	6	250,000	0	0	0	0	6	250,000	—
Banking Law Expert	0.25						0.25		
Salary		3,000						3,000	
Travel		4,000						4,000	
Subsistence	—	—	120,000	—	—	—	—	—	120,000
	0.25	7,000	120,000	0	0	0	0	7,000	120,000
Technology Consultant	3						3		
Salary		21,000						21,000	
Travel		14,000						14,000	
Subsistence	3	—	1,800,000	—	0	0	—	—	1,800,000
	3	35,000	1,800,000	0	0	0	3	35,000	1,800,000
TOTAL RECURRENT EXPENDITURES	37.25	582,000	8,080,000	28	260,000	6,160,000	65.25	842,000	14,240,000
TOTAL EXPENDITURES	37.25	587,000	8,080,000	28	265,000	6,160,000	65.25	852,188	14,240,000

ANNEX 3-4

GHANA

FINANCIAL SECTOR ADJUSTMENT CREDIT

TECHNICAL ASSISTANCE TO SUPPORT THE ESTABLISHMENT OF A CREDIT CLEARING HOUSE

A. BACKGROUND

1. One of the major problems in the Ghanaian banking system is unduly large exposure and loan concentration, largely as a result of State majority ownership in a number of banks and enterprises, inadequate banking legislation, and defective management practices. Improving the transparency of risk concentration among banks and from banks to the BOG would lead to more prudent lending by banks and to better supervision by BOG. This could be achieved through the establishment a "Centrale de Risques" or "Credit Clearing House" (CCH) along the lines of similar institutions that exist in other countries.

2. The CCH to be established would make it mandatory for banks to regularly report on any risk (working capital, term loans or guarantees) above a certain limit on any single company or group of companies. After proper computerization by the CCH, each bank would be allowed to receive information on the aggregated risk of each company or group with the whole banking system (the risky position with any single bank would, of course, not be disclosed.) The system should include all banks, whether commercial or development banks, privately or publicly owned.

3. The system could be implemented gradually, starting with risks above the cedi equivalent of US$100,000. Once the system has been tested, the minimum level could be gradually lowered to US$50,000 and possibly to US$25,000. Rural banks could use different standards.

4. The CCH should be operated by the BOG. However, if reasons of public confidence warrant it, it could be established by the Bankers' Association, provided BOG has the possibility to monitor and inspect its operations and to have regular access to the information necessary for supervisory purposes.

B. SCOPE FOR TECHNICAL ASSISTANCE

5. The program for assisting in the setting up of the CCH would include: (i) Appointment of a technical advisor; (ii) Training for BOG's staff; and (iii) Computer equipment.

6. Owing to the complexity of the proposed mechanism, specialized foreign expertise would be needed. Twelve man-months of advisory services would be required--to be provided consecutively or in successive periods. The technical advisor would have to design the system, train staff, assist in the selection of computer equipment and supervise the initial stage of implementation until smooth operation is achieved. Purchase of the necessary computer equipment would also be financed.

7. A preliminary survey to be carried out by an expert for about three weeks would lead to the preparation of a more detailed action program project.

AF4IE
March 1988

GHANA

FINANCIAL SECTOR ADJUSTMENT CREDIT

TECHNICAL ASSISTANCE FOR THE INSTITUTE OF CHARTERED ACCOUNTANTS

A. Background

1. The Institute of Chartered Accountants (Ghana) was established under an Act of Parliament in 1963. It is the sole body charged with the development and regulation of the accountancy profession in Ghana. Its statutory functions include:

(a) the conduct of qualifying examinations for membership of the Institute;

(b) the supervision of professional standards and ethics among members of the Institute; and,

(c) the duty to maintain a library of books and other literature on accountancy and related subjects and to encourage publication of such literature.

2. The governing body of the Institute is the Council consisting of eleven members all of whom must be members of the Institute and who render voluntary service to the Institute for no remuneration. The Institute has a Secretariat of fifteen members of staff headed by an Executive Secretary. Presently, the membership of the Institute stands at 400, with 3,500 registered students at various stages of the qualifying professional examinations of the Institute. The Institute is a member of the International Federation of Accountants (IFAC). It is also a founding member of the Association of Accountancy Bodies in West Africa (ABWA), a sub-regional body of the IFAC, whose objectives include the development and enhancement of the accountancy profession and the promotion and development of professional ethics and accountancy standards and practices in West Africa.

3. In order to strengthen the framework within which financial institutions operate, a strong accounting profession is needed to enhance the reliability of financial information, to strengthen audits of banks to provide a true and accurate picture of each bank's financial condition, and to assist in upgrading the quality of operations and systems employed by these institutions. However, in Ghana, weaknesses in the accounting profession have failed to disclose the enormity of problems present in the financial institutions. Accounting standards need to be strengthened to prevent the capitalization of interest, to preclude the accrual of interest into income on non-performing assets, to mandate provisions for problem assets, and to force the recognition of losses on bad assets. Further, the training and skills level of accountants need to be strengthened through

modernization of the qualifying examination process, continuing education, and provision of research and advisory facilities.

4. Continuing efforts to train accountants locally, to keep pace with current events in accountancy, and to develop the profession in Ghana have met with numerous problems including:

(a) inadequate financing to support the Institute's activities;

(b) an insufficient supply of qualified teaching personnel;

(c) an inappropriate structure for the training and education of accountants;

(d) a lack of adequate teaching materials, books, and other teaching aids; and,

(e) a lack of current accounting literature necessary to keep pace with worldwide developments in the profession.

B. Concept for Technical Assistance

5. There should be several components to assist the Institute of Chartered Accountants in strengthening the accounting profession in Ghana. The components are:

(a) appointment of two technical advisors;

(b) training, teaching aids, and equipment;

(c) reference library; and

(d) motor vehicles.

Technical Advisors

6. To strengthen the accounting profession, specialized expertise is needed from abroad. Two advisors should be appointed for an initial two-year assignment to work within the Institute of Chartered Accountants. These advisors should be qualified certified or chartered accountants, preferably from the UK Chartered Association of Certified Accountants or the Institute of Chartered Accountants in England and Wales. Their functions should be as follows:

(a) One advisor will be responsible for setting up a Practice Advisory Service to give professional counselling or a second opinion to practitioners on technical matters relating to auditing, accounting, and allied areas. This service will be of particular use to sole practitioners and smaller firms who do not have the resources for such services in-house.

(b) The other advisor will be responsible for setting up and developing a Technical Department. The Department will be responsible for initiating and organizing:

(i) the technical and research programs of the Institute;

(ii) the continuing professional education program for the professional development of the members of the Institute;

(iii) the development of teaching aids and other material to incorporate material and examples related to the local environment;

(iv) the review and update of the examination syllabus of the Institute; and,

(v) workshops for examiners and moderators who administer the Institute's professional examinations.

7. The Institute has advertised for the appointment locally of a professionally qualified accountant who will be developed into a competent and effective Technical Director. The Technical Advisor will contribute to his professional development.

Training, Teaching Aids, and Equipment

8. Training is an integral part of the process to upgrade the accountancy profession in Ghana. Therefore, a program is recommended combining the following features:

(a) a program of continuing professional education for members of the Institute to be organized and conducted by one of the technical advisors. This program is to be supplemented by experts from the United Kingdom to conduct seminars on specialized areas such as computers, international accounting standards and international auditing practices. It is envisaged that two foreign experts will participate in two-week seminars to be conducted twice a year in Ghana;

(b) provision for the Technical Director to attend up to four two-week training seminars abroad during a two-year period;

(c) a program of training for examiners and moderators of the Institute's qualifying professional examinations to be organized by one of the technical advisors. It is envisaged that two foreign experts will participate in one two-week seminar to be held in Ghana each year;

(d) fellowships for three members of the Institute to travel abroad each year and participate in professional development courses conducted by a recognized accounting body; and

(e) provision for teaching aids and equipment.

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Reference Library

9. Current literature concerning accountancy, auditing, and allied subjects is lacking and, therefore, serves to constrain the development and modernization of the accountancy profession in Ghana. There is an urgent need for textbooks, reference materials, technical bulletins, and periodicals, as well as microfilm readers and other library equipment, to assist members of the Institute and students in their professional development.

Motor Vehicles

10. The technical advisors will require vehicles for transportation during their assignments. In addition, a vehicle is necessary for upcountry visits to universities and other institutions for work related to the Institute.

C. Technical Assistance Program Cost Estimates

Capital Expenditures

11. (a) The cost of teachings aids to be used in continuing professional education courses is estimated at US$15,000. This includes monies for two video recorders, four TV monitors, twelve videotapes, two personal computers, software, and peripherals, and two overhead projectors and accessories.

(b) The cost of books, reference materials, photocopies, and other classroom aids to be used in continuing professional education courses is estimated at US$5,000 per year.

(c) The cost of procuring textbooks, reference books, technical bulletins, periodicals, and other reference materials for the Institute's library is estimated at US$50,000 per year for two years. This estimate represents the initial capital costs necessary to bring the library up to standard. At present, less than 25% of available shelf space is filled.

(d) The cost of three motor vehicles is estimated at US$40,000. Two vehicles are to be used by the technical advisors. The third vehicle, a four-wheel drive, is to be used for upcountry visits to universities and other institutions.

Recurrent Expenditures

12. (a) The cost of salaries and benefits, relocation and settling in expenses, housing and amenities for two accountancy advisors for a period of two years is estimated at US$360,000 and 12,000,000 cedis.

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(b) Travel, subsistence, and enrollment fees for (1) two foreign experts to instruct in two two-week continuing professional education courses each year and for (2) two foreign experts to conduct a two-week course for examiners and moderators each year are estimated at US$50,000 and 240,000 cedis each year for two years.

(c) Salary, travel, and subsistence expenses for (1) two foreign experts to instruct in two two-week continuing professional education courses each year and for (2) two foreign experts to conduct a two-week course for examiners and moderators each year are estimated at US$50,000 and 240,000 cedis each year for two years.

13. A budget for technical assistance program cost estimates follows on subsequent pages.

BUDGET FOR INSTITUTE OF CHARTERED ACCOUNTANTS ASSISTANCE PROGRAM

	1988			1989			Total		
	Man Months	Foreign $	Local Costs	Man Months	Foreign $	Local Costs	Man Months	Foreign $	Local Costs
A. Capital Expenditures									
Teaching Aids		15,000						15,000	
Books, reference materials, classroom aids, etc.		5,000			5,000			10,000	
Reference Library		50,000			50,000			100,000	
Motor Vehicles		40,000						40,000	
TOTAL CAPITAL EXPENDITURES		110,000	0		55,000	0		165,000	0
B. Recurrent Expenditures									
Accountancy Advisors	24			24			48		
Salaries		100,000			100,000			200,000	
Benefits		30,000			30,000			60,000	
Relocation/Settling In		50,000			50,000			100,000	
Housing and Amenities			6,000,000			6,000,000			12,000,000
	24	180,000	6,000,000	24	180,000	6,000,000	48	360,000	12,000,000
Seminars Abroad	3			3			6		
Fees		9,000			9,000			18,000	
Travel		12,000			12,000			24,000	
Subsistence		15,000			15,000			30,000	
	3	36,000	0	3	36,000	0	6	72,000	0
Foreign Instructors	3			3			6		
Salaries		30,000			30,000			60,000	
Travel		20,000			20,000			40,000	
Subsistence			240,000			240,000			480,000
	3	50,000	240,000	3	50,000	240,000	6	100,000	480,000
TOTAL RECURRENT EXPENDITURES	30	266,000	6,240,000	30	266,000	6,240,000	60	532,000	12,480,000
TOTAL EXPENDITURES	30	376,000	6,240,000	30	321,000	6,240,000	60	697,000	12,480,000

GHANA

FINANCIAL SECTOR ADJUSTMENT CREDIT

TECHNICAL ASSISTANCE PROGRAM FOR BANKERS' TRAINING

A. Background

1. The Government of Ghana has embarked on a program of development and liberalization in its financial markets. As part of this program, the banking system, which has operated within an oligopolistic environment, will operate within a more open and competitive environment leading to greater efficiency and modernization. Lending policies of banks which, in the past, sought to meet social goals will, in the future, be predicated on more prudent banking principles. These changes in the banking system require stronger banking skills and expertise at all levels, a more professional approach to management of financial institutions, and greater depth in the ranks of management. To upgrade the skills and expertise of banking personnel, a bankers' training program is proposed.

2. The need to upgrade the skills of new and existing personnel, particularly at the management and professional levels, can best be addressed by first designating an appropriate body to organize and coordinate training needs for the entire banking industry. The Bank of Ghana is the logical focal point for this body in the absence of a strong bankers' association. Bringing management and professional level personnel together for training would offer substantial economies of scale, reduce training staff to a manageable level, permit specialized expertise to be brought from abroad to participate and instruct in training courses, and provide a sharing of experience and a discussion of problems common to the local environment with the hope of improving banking practices and resolving common problems.

3. The objectives of providing management and professional level training would be to:

(a) Upgrade and internationalize banking skills in the core functions of management, lending/marketing, operations/technology, planning/financial management, and treasury/asset and liability management.

(b) Develop a more professional approach to management and to upgrade the quality of management systems used by financial institutions in Ghana.

(c) Introduce the most recent developments and techniques in banking and the financial markets.

(d) Upgrade the quality of training materials and instruction conducted in-house within banks in Ghana through the transfer of skills, technology, and knowledge from abroad.

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4. In addition to training at the management and professional level, assistance at the institutional level is needed to support training of clerical and support staff in-house or in cooperation with the Ghana Institute of Bankers. This assistance includes support for curses in fundamental banking skills and the theory of banking, training materials and teaching aids, and motor vehicles to transport instructors and students.

B. Concept for Training Program

5. There should be several components to strengthen the skills and knowledge of the banking profession in Ghana. The components are:

(a) Seminars and courses for managerial and professional level staff to be conducted locally and abroad.

(b) Teaching aids, reference materials, equipment, and motor vehicles.

(c) Financing to support the work of the Ghana Bankers' Institute, to enable it to develop and strengthen its own capabilities for training bankers in Ghana.

Managerial and Professional Level Training

6. Managerial and professional level training is required at all levels of management. The most critical training needs are in the areas of management, credit, asset and liability management, foreign exchange management, and planning. To meet these needs, a program of continuous professional education is recommended which features seminars conducted both locally and abroad. (The decision of whether to hold a seminar locally or abroad will largely depend upon the number of personnel to be trained in a particular skill and the degree of specialization required).

7. The core courses recommended are:

(a) Entry and Junior-Level Managers and Professionals

(1) Financial Statement Analysis
(2) Introductory Foreign Exchange Management
(3) Microcomputers
(4) Bank Accounting
(5) Money and Banking
(6) Cash Management Services and Operations
(7) Introduction to Asset and Liability Management
(8) Introductory Credit Analysis
(9) Marketing
(10) Managing People
(11) Introductory International Banking
(12) Project Management and Appraisal
(13) Banking Laws and Regulations
(14) Audit and Compliance Systems

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(b) Mid-Level Managers and Professionals

(1) Intermediate Foreign Exchange Management
(2) Intermediate Credit Analysis
(3) Intermediate Asset and Liability Management/Treasury
(4) Intermediate International Banking
(5) Intermediate Management Seminar
(6) Establishing Effective Internal Controls
(7) Problem Loan Identification, Workout, and Debt Recovery

(c) Senior-Level Managers and Professionals

(1) Advanced Management Skills (i.e., managing people)
(2) Strategic Planning
(3) Advanced Foreign Exchange Management
(4) Developing Written Policies
(5) Advanced Credit Analysis
(6) Advanced Asset and Liability Management/Treasury
(7) Advanced International Banking
(8) Establishing an Effective Loan Review System
(9) Establishing an Effective Audit System
(10) Management Information Systems
(11) Financial Planning and Budgeting
(12) Human Resource Management
(13) Establishing an Adequate Loan Loss Reserve
(14) Capital Planning
(15) Loan Portfolio Management

(d) Directors

(1) Duties and Responsibilities of Directors
(2) Strategic Planning
(3) External and Internal Audit
(4) Banking Laws and Regulations

8. In addition, specialized courses are recommended for professionals engaged in law, research, training, and other fields. For legal staff, courses concerning the legal aspects of debt recovery, project procurement and contract negotiation, international financing sources and techniques, public and parastatal enterprises, loan negotiation and renegotiation, foreign direct investment and joint venture negotiation, etc. are recommended. For research staff, courses in advanced research techniques are recommended. For instructors, train the trainer seminars are suggested.

Teaching Aids, Reference Materials, and Equipment

9. Teaching aids, reference materials and equipment are needed to support training activities. These include audio visual aids, overhead projectors, microcomputers, slide projectors, video equipment, copying machines, stationery, textbooks, and library facilities. Motor vehicles are needed to transport instructors and students to training facilities.

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Ghana Bankers' Institute

10. The Ghana Institute of Bankers' educational program seeks to provide the appropriate academic foundation for a professional-oriented career and a professional qualification designed to improve job performance and demonstrate a commitment to the banking profession.

11. The banking qualification is in two parts. The Stage 1 examination covers English, economics, the structure of accounts, general principles of law, and elements of banking. The Stage 1 examination is administered locally. The Stage 2 qualification covers banking law, monetary economics, accountancy, investment, the nature of management, the finance of international trade, and the practice of banking (parts 1 and 2). The Stage 2 qualification is administered from London by the British Institute of Bankers.

12. Part-time evening classes are held at three locations: Accra, Kumasi, and Tema. Self-study and correspondence courses are other options available to students trying to acquire the knowledge to pass the qualifying examinations. However, a lack of textbooks, student materials, and the high-cost of correspondence courses make the last two approaches less effective than part-time evening classes.

13. To strengthen the work of the Institute in providing banking education, the following technical assistance program is suggested:

(a) Revision of the course curriculum and examination syllabus to reflect local needs, changes in the operating environment, and recent developments and technological advances in the industry.

(b) Training of tutors and examiners as part of a program to localize the Stage 2 qualifying examination.

(c) Financial support for the purchase of textbooks and reference materials for students.

(d) Library facilities and associated equipment, textbooks, periodicals, and reference materials.

(e) Instructional aids including video equipment, overhead projectors, copying machines, microcomputers, printing equipment, and motor vehicles to transport instructors and students.

C. Technical Assistance Program Cost Estimates

Capital Expenditures

14. (a) The cost of teaching aids, textbooks, reference materials, overhead projectors, slide projectors, video equipment, copying machines, microcomputers, and printing equipment is estimated at US$90,000 for 1988 and US$45,000 for 1989. The amounts are allocated between the Bank of Ghana (two-thirds), as coordinator

for the managerial and professional level bankers' training programs, and the Ghana Institute of Bankers (one-third).

(b) The cost of stocking a reference library with appropriate reference materials, textbooks, library equipment is estimated at US$50,000 per year for two years. The library facility will be maintained and operated by the Ghana Institute of Bankers. However, the facility will be available for use by all banking professionals.

(c) The cost of motor vehicles is estimated at US$100,000. These vehicles are to be used to transport instructors and students to classes. The estimate provides for three buses (allocated to the National Savings and Credit Bank, the Ghana Institute of Bankers, and the Bank of Ghana) and one automobile (allocated to the Ghana Institute of Bankers).

Recurrent Expenditures

15. (a) Foreign instructors are expected to expend 20 man-months per year conducting courses in banking at the professional and managerial level. Salaries are estimated at US$120,000 per year. Travel is also estimated at US$120,000 per year. Annual subsistence expenses are estimated at 8,400,000 cedis.

(b) Provision is made for eight persons from each of the nine largest banks and the Bank of Ghana to attend seminars abroad each year. Fees are estimated at US$120,000, travel at US$160,000, and subsistence at US$170,000 per year.

(c) Provision is made for three persons from the Ghana Institute of Bankers to attend seminars abroad each year for the purposes of acquiring the skills necessary to upgrade the course syllabus, becoming acquainted with recent developments in the banking industry, and training tutors and examiners in order to localize the Stage 2 qualifying examination. Costs are estimated at US$4,500 for fees, US$6,000 for travel, and US$6,300 for subsistence.

16. A budget for technical assistance program cost estimates follows on the subsequent page.

BUDGET FOR BANKERS' TRAINING

	1988			1989			Total		
	Man Months	Foreign $	Local Cedis	Man Months	Foreign $	Local Cedis	Man Months	Foreign $	Local Cedis
A. Capital Expenditures									
Teaching Aids		30,000			30,000			60,000	
Books, reference materials, classroom aids, etc.		60,000			15,000			75,000	
Reference Library		50,000			50,000			100,000	
Motor Vehicles		100,000						100,000	
TOTAL CAPITAL EXPENDITURES		240,000	0		95,000	0		335,000	0
B. Recurrent Expenditures									
Seminars Held	41.5			41.5			83.0		
Fees		134,500			134,500			269,000	
Travel		188,000			188,000			376,000	
Subsistence		178,300			178,300			356,600	
	41.5	498,800	0	41.5	498,800	0	83.0	997,600	0
Foreign Instructors	20.0			20.0			40.0		
Salaries		120,000			120,000			240,000	
Travel		120,000			120,000			240,000	
Subsistence			8,400,000			8,400,000	40.0		16,800,000
	20.0	240,000	8,400,000	20.0	240,000	8,400,000	40.0	480,000	16,800,000
TOTAL RECURRENT EXPENDITURES	61.5	706,800	8,400,000	61.5	706,800	8,400,000	123.0	1,413,600	16,800,000
TOTAL EXPENDITURES	61.5	946,800	8,400,000	61.5	801,800	8,400,000	123.0	1,748,600	16,800,000

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ANNEX 3-7

GHANA

FINANCIAL SECTOR ADJUSTMENT CREDIT

TERMS OF REFERENCE FOR A BANK RESTRUCTURING ADVISER

1. The adviser will be stationed in Accra, Ghana, for a period of 18 months (consecutively, or in 3 separate semesters) to work as a resource person with the Technical Committee in charge of monitoring the proper implementation of the bank restructuring program. The latter is a Government entity in the process of being established, the core of which would comprise senior officials from the Central Bank and the Ministry of Finance, and which will be charge of directing, coordinating and overseeing the implementation of an ongoing program for restructuring the Ghanaian banking sector. He will:

- help the Technical Committee design mechanisms to systematically deal with insolvent banks in terms of both financial and managerial restructuring;
- assist in establishing the regulatory and institutional framework to that effect;
- develop a package of policies and procedures to restructure insolvent institutions through remedial management measures, removal of existing losses, liquidation of bad assets and access of new shareholders to ownership;
- help the Technical Committee and/or the management of individual banks prepare, review and refine specific action programs and/or restructuring proposals; and advise the management of the banks undergoing restructuring in their initial implementation stage; and
- assist the authorities in generally overseeing the implementation of the bank restructuring program and monitoring its progress.

AF4IE
April 1988

GHANA

FINANCIAL SECTOR ADJUSTMENT CREDIT

CORPORATE RESTRUCTURING

Background

1. As evidence appears in the partial results already available on banks' audits, a large number of Ghanaian enterprises, particularly those in the industrial sector, have greatly suffered from the adverse effect of massive devaluations, high inflation rates, trade liberalization, reduction in effective protection rates, and other reforms of the adjustment program, which are expected to result in the medium-term in the development of a stronger, more efficient and more competitive corporate sector. The sharp deterioration in the financial situation of enterprises, however, and its strong bearing on the health of the financial system, justifies the consideration in the proposed project of the initialization of a program for restructuring Ghanaian enterprises in financial distress. The basic objective of such a component will be to offer a comprehensive package to financially-distressed enterprises with clear medium-term prospects for profitable operations. Although the responsibility for rehabilitation/restructuring should rest in principle with the banks, the magnitude and intricacy of the problem and the current weak status of most financial institutions will require both important financial resource and high-level technical expertise, and might justify the establishment of a specialized financial corporation through which corporate restructuring proposals would be prepared, negotiated and implemented. An assessment of the need for a corporate restructuring program and proposals on its composition, covering in particular the conceptualization and design of the required regulatory and institutional support, would be undertaken under this project. A preliminary study is expected to be initiated during project preparation under PPF financing (Annex 3-8). If the conditions are felt propitious, this assessment would lead to the undertaking of a pilot program with a modest initial-funding in the vicinity of US$15 million (funded by the Government and by the banks).

Some Elements of Enterprise Restructuring

2. Objectives and Investments. The basic objective of enterprise restructuring is to offer comprehensive financial packages linking future debt repayments to the cash-generation capacity of each individual firm. Typically, a financial package could include: (a) debt swapping with equity or quasi-equity instruments such as convertible debentures or non-voting preferred shares; (b) rescheduling of the remaining debt over longer maturities; (c) capitalization of interests; (d) write-off of part of accumulated penalties and other charges; (e) injection of fresh money for working capital; and (f) investments in new fixed assets. There would be as well a need to provide technical assistance both to banks and to enterprises for preparing and implementing restructuring proposals.

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3. Conditions for Restructuring. Restructuring should be selective and confined to firms temporarily experiencing financial distress (usually on account of over indebtedness) but with clear medium-term prospects for profitable operation, as demonstrated by a thorough appraisal and supported by a specific, restructuring proposal. The latter would contain four basic elements: (a) a management plan, including any organizational arrangements as deemed necessary; (b) a marketing plan, including any product redesign; (c) a production plan linked to the marketing plan, including either curtailment or fuller utilization of capacity; and (d) a financial workout plan that would reflect the elements listed in paragraph 3, as well as internal measures to reduce financial burden such as (i) streamlining of administrative expenses and (ii) sale of non-essential assets.

Involvement of Ghanaian Banks

4. The responsibility for rehabilitation/restructuring of enterprises should rest partially with the Ghanaian commercial/development banks, who will have to take the lead, because of their knowledge of client companies and their interest in seeking to improve their own loan portfolios. The financial strengthening of the banks will ultimately critically depend on the financial condition of borrowing enterprises. However, if left to their own devices and to act individually, the Ghanaian banks may not be able to do much in relation to the magnitude of the problem, the resolution of which requires both financial resources and technical expertise.

Institutional and Financial Arrangements

5. In light of the foregoing, there appears to be a need for exploring appropriate support measures at the country level, both institutional and financial, to supplement and coordinate the efforts to be undertaken by individual banks.

6. Consideration would have to be given to some institutional framework through which corporate restructuring proposals would be designed, appraised, reviewed, negotiated, financed and implemented. One alternative would be to set up a new specialized financial corporation, or some trust fund, to be funded by GOG/BOG (through possible external resources as well as domestic), with some participation by the Ghanaian banking system. The new entity, acting as an apex institution, would oversee the overall program as well as refinance (including the acquisition of the equity in the enterprises to be restructured held by the banks as a result of debt/equity swap arrangements) up to a fixed percentage individual of restructuring proposals submitted by the banks;

7. The financial requirements for restructuring Ghanaian enterprises are not presently known, and will be difficult to determine with any degree of accuracy. The completion of the banks' audits will give an assessment of their loan portfolios, and therefrom some idea of the (maximum) extent of corporate restructuring, although, as noted earlier in para 3, restructuring should be selected and limited to those enterprises with

clearly demonstrated prospects. The initial funding for the pilot program should therefore be relatively modest to be replenished in due course assuming successful implementation of the program.

8. Technical assistance would be needed to help set up and operate the Apex institution including provision for consultancy services to assist in the preparation/appraisal/review of enterprise workout proposals. Initially, expert assistance would be needed to help conceptualize the program (which is touched upon here only in a preliminary way) and to draw up operating guidelines and procedures. Consideration would also be given to whether there is a need to proceed first with a preliminary study to assess the impact of recent adjustment policies (including devaluations and trade liberalization) on enterprises, and the extent of rehabilitation investments and financial restructuring needed. The preliminary study is expected to be initiated during project preparation under PPF financing.

ANNEX 3-9

GHANA

FINANCIAL SECTOR ADJUSTMENT CREDIT

TECHNICAL ASSISTANCE AND STUDIES

Summary of Costs

		US$	Cedis ('000)	
1.	Bank of Ghana (Annex 3-3)	850,000	14,250	
2.	Credit Clearing House (Annex 3-4)	150,000	4,500	
3.	Institute of Chartered Accountants (Annex 3-5)	700,000	12,500	
4.	Training of Bankers (Annex 3-6)	1,750,000	16,900	
5.	Consolidated Discount House and Study on Capital Markets (Annexes 3-1 and 3-2)	75,000	1,500	
6.	Corporate Restructuring (Study)	300,000	6,000	
7.	Bank Restructuring (Adviser)	225,000	6,750	
8.	Exchange Risk (Study)	75,000	1,500	
9.	Contingency and Others	450,000	12,600	
	Total	4,575,000	76,500	
	(Total US$ equivalent)	(4,575,000)	(425,000)	(5,000,000)

The project would finance 100% of total expenditures.

In order of reply the number and date of this letter should be quoted.

Our Ref. No. SEC/FP/036

Your Ref. No. ——

REPUBLIC OF GHANA

MINISTRY OF FINANCE AND
ECONOMIC PLANNING
P.O. BOX M.40
ACCRA

11th March, 1988.

MR. BARBER B. CONABLE,
PRESIDENT,
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT,
1818 h. STREET N.W.,
WASHINGTON D.C.,
U.S.A.

Dear Mr. President,

RE: FINANCIAL SECTOR ADJUSTMENT PROJECT
STATEMENT OF FINANCIAL POLICY

As part of its Economic Recovery Program, the Government of Ghana is undertaking a program of institutional and policy reforms of the financial system. This statement outlines the objectives of such an Action Program and the framework within which the reforms have been formulated. An implementation schedule for the main policy actions is annexed. The Government of Ghana requests from the International Development Association consideration of a Financial Sector Adjustment Credit to support the implementation of this Action Program.

OBJECTIVES AND SCOPE OF THE PROGRAM

1. A well functioning and broadly based financial sector, with an effective banking system at its core, is necessary to support the structural adjustment effort. Yet Ghana's financial system is fragile. It is still at an early stage of its development and is handicapped by significant institutional weaknesses, limited mobilization of financial resources, and deficiencies in credit allocation, all of which have constrained the supply of credit to the productive sectors. Rural areas in particular have suffered from inadequate credit and financial services. Formal financial intermediation is low, with the broad money to GDP ratio averaging around 17 per cent in 1986 (after falling to a low of 13 per cent in 1984 from a level of well over 20 per cent during the 1970s). Myriads of money lenders, thrift groups, trusts and other unregulated financial agencies with only limited interactions with the formal system, exist all over the country and it is to these that a large part of the population turn to for financial intermediation.

2. The Government of Ghana has decided to address these handicaps. The Government's action program aims to strengthen financial institutions, expand the scope of the formal financial system, and improve the efficiency of financial intermediation in Ghana. Emphasis is placed on priority policy and institutional reforms necessary to overcome the key constraints or imperfections in the financial system which are hindering the flow of funds to the efficient productive sectors, thus limiting investment and production responses to the ongoing adjustments of trade and incentive policies. The restored health of financial institutions is of overriding concern. The reforms required to meet these aims are grouped under four principal heads: (i) enhanced soundness of banking institutions through an improved regulatory framework, strengthened banking supervision by the Bank of Ghana, and the

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restructuring of financially distressed banks; (ii) improved mobilization and allocation of financial resources including development of money and security markets; and (iii) improved mechanisms for rural finance.

3. The necessity to ensure that the coverage of the initial action program is of manageable dimensions has meant that important medium and long-term issues related to, for example, integration of the regulated and unregulated financial markets, and the basic structure of the financial systems have only received partial attention; these issues will form an important part of the on-going reviews of the financial sector. However, the overall framework within which the priority reforms have been have been formulated envisages a move towards a considerably less regulated and more competitive and efficient financial system, with the Bank of Ghana's principal role being to effectively manage key monetary aggregates, ensure compliance with banking regulations, and monitor the health of the financial institutions. Banking prudence, institutional viability, and reasonable operating autonomy must be maintained by banks, while at the same time they must be responsive to market forces and sensitive to national development priorities. Reliance would be placed on a relatively free functioning market for the channelling of credit, although limited Government intervention may be necessary where market failures prevent funds from reaching disadvantaged groups.

4. The action program covers a two year period and will be continually revised to reflect the progress in implementation, assessments of the impact of the reforms and the results of the various daignostic studies and related follow-up being undertaken. It will also be revised, where appropriate, to incorporate the findings of the on-going reviews of issues which have not yet been adequately addressed. It will thus be a 'rolling' program, extending over a number of years. A high level Financial Sector Adjustment Committee chaired by the Secretary for Finance and Economic Planning, with the Governor of the Bank of Ghana as Vice-Chairman, and reporting to the Chairman, Committee of Secretaries, will oversee the implementation of the program.

Enhanced Soundness of Banking Institutions

5. The supervisory functions of the Bank of Ghana will be substantially strengthened so that it can carry out effectively its role of monitoring and preserving the health of the financial system. However, the Bank of Ghana will ensure that a careful balance is maintained between sound and effective banking supervision, and without undue interference in the day-to-day operations of the respective banks. The supervisory functions of the Bank of Ghana will apply equally to all banks and non-bank financial institutioins. In the case of rural and specialized banks, aspects of the supervision - though not compromised - may take on slightly different forms (e.g. reporting formats).

6. The effectiveness of banking supervision is largely dependent upon the strengthening of staff capabilities within the relevant departments of the Bank of Ghana, updating of and adherence to procedures, enforcement of existing laws and regulations, logistical support, and encouragement and assistance given to individual banks to improve their own internal controls. Although the Banking Act and its regulations provides a generally acceptable framework and legal basis for regulating and supervising the banking system,

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amendments relating to prudential aspects, including capital adequacy, portfolio classification, exposure limits, and auditing and reporting standards and requirements for banks will be undertaken.

Banking Restructuring

7. A large number of Ghanaian banks are facing severe financial difficulties, which threaten their liquidity and solvency and thereby the stability of the whole financial system. Although this is particularly true of the three development banks, most commercial banks are also affected. Several factors contributed to this situation, including inadequate banking supervision by the authorities, inappropriate sector policies and regulations affecting the operation of the banks, as well as the rapid depreciation of the cedi in recent years, which increased the indebtedness of the corporate sector, reduced its capacity to service its debts to the banks, and consequently weakened the asset portfolio of the banking system. Poor management has also played a major role in this respect.

8. The Government realizes the need to restructure the distressed Ghanaian banks with a view to restoring their financial and operational viability. As a first step, special diagnostic studies (audits) by international consulting firms have been carried out for the three development banks and most of the commercial banks, to determine their financial/operational condition and the appropriate measures required to remedy their situation. These audits will be subject to systematic review by the Ghanaian authorities in consultation with IDA. The first main objective of such reviews will be to ascertain the magnitude of the financial deficits of the individual banks (and by extension, of the banking system overall) and to decide on an appropriate future course of action (e.g. merger, recapitalization, restructuring) for each bank to be agreed with IDA, based on a realistic assessment of its prospects for future viable financial operation as well as of the role it can be expected to play within the reformed Ghanaian banking system. The second main objective of this review process will be to decide on the appropriate modalities (such as injection of fresh money; conversion/rescheduling of debts owed to Government/BOG and external lenders by the banks; transfer to the Government of non-performing loans to state enterprises and/or guaranteed by Government) for the complete resolution of these deficits, so as to restore the solvency of banking institutions. Any decision to reacapitalize/restructure a distressed bank for future operation (beyond the mere settlement of its accumulated deficits) would be also subject to business projections covering not less than a 5 year period, based on explicit and realistic assumptions, indicating the bank's prospective capacity to operate profitably on competitive terms. The decision to restructure a bank would then be reflected in a comprehensive restructuring plan specifying all necessary arrangements (financial, organizational, managerial) to ensure the bank's successful rehabilitation. This restructuring plan, when available, will be jointly reviewed and agreed with IDA, and subsequently embodied in performance contracts between the Government of Ghana and each of the banks setting out the respective commitments and obligations of the Government and of the bank concerned.

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9. It is the Government's intention to carry out the restructuing of the banking system in accordance with the overall thrust of the Action Program and sound banking principles, some of which are listed below. First, financial restructuring (that is, the injection of fresh money into a bank to clean up its balance sheet and to recapitalize it for future operation) will not be attempted in isolation from a simultaneous or prior managerial/organizational restructuring that would ensure the proper use of the new resources and more generally the non-recurrence of past mistakes. Second, all restructured banks will have independent, professional management with autonomy in day-to-day affairs and investment decisions. To this end, qualified managers will be sought as necessary. The management of the banks will be accountable for their performance. Even for those banks with predominant state ownership, the Board of Directors would include appropriate members from the private sector so as to broaden its range of expertise and enhance its business outlook. Third, the Government would be prepared if warranted to consider gradually reducing its share ownership (and hence, its managerial responsibility) in banking institutions, by seeking significant private Ghanaian participation along with foreign participation in the restructured banks. This would include, in particular, the participation of development-oriented multilaterial and/or bilaterial organizations. Subject to proper safeguards, the entry into the banking system of new banks with private ownership and management, both domestic and foreign, will be encouraged. Fourth, pending the outcome of the ongoing banking restructuring process, appropriate safeguard measures will be taken where necessary to arrest the further financial deterioratioin of banks, including the discontinuation/curtailment of new lending (which is to be done only on a stringent basis), utmost concentration on loan recoveries, reduction in operating costs, reconciliation of accounts where inconsistencies/discrepancies were identified by the audits. Fifth and lastly, the basic objective of banking restructuring, consistent with the Action Program, is to foster the emergence and growth of a sound, dynamic banking system in which all banks, irrespective of ownership, development or commercial, will compete freely and operate by the rules of the market.

Corporate Sector Restructuring

10. A large number of Ghanaians enterprises, including those in the industrial sector, are in urgent need of physical as well as financial restructuring. Several have been unable to respond to the new incentive policies of the Government because of their fragile financial position. Crippled by large debts, in many cases denominated in foreign currency, their debt-service obligations have mounted rapidly as the cedi has depreciated. The basic objective of enterprise restructuring is to offer a comprehensive program including a financial package linking future debt repayments to the cash generatioin capacity of individual enterprises. Significant managerial and operational restructuring would have to be considered as well. Restructuring will be selective and confined to those enterprises temporarily in financial distress but with clear medium-term prospects for profitable operation. Corporate restructuring will require the involvement of the Ghanaian banks, because they know their clients well, and because they have an interest in improving their own loan portfolios. However, given the limited expertise in the Ghanaian banks at present, the Government will give consideration to a program or framework at the national level that would provide both the requisite technical expertise and supplementary financial

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resources (possibly in the form of a refinancing mechanism, or a trust fund for equity participation). In light of the foregoing, the Government would appreciate IDA's assistance in undertaking a study that would (i) provide an up-to-date assessment of the restucturing requirements, both physical and financial, of the Ghanaian industrial sector, covering major sub-sectors, and industrial SOEs as well as private firms; and (ii) recommend an appropriate program (institutional framework, methodology, mechanisms, guidelines) for corporate reconstructuring. This study, upon its completion, will be reviewed by the Government and IDA, as a basis for future action.

Improved Mobilization and Allocation of Financial Resources

11. In September 1987, the Government liberialized all interest rates on deposits and credits, except rates for savings deposits which were liberalized in February 1988. The Government will agree with IDA by February 1989 upon a timetable for the phased decontrol of banking charges. Moreover, the Government will undertake parallel actions to further enhace banking confidence. The increased soundness of the financial institutions emerging from the improved supervision of the Bank of Ghana will play a positive role in this.

12. Within the Government's overall ceilings on credit expansion, and following the full liberalization of credit rates, further steps have ben taken by dismantling in February 1988 sectoral targets on lending; targets for lending to agriculture will be reviewed by December 1989 in the context of the proposed rural finance subsector project in particular, and the overall financial sector program, with a view to taking appropriate actions. Special credit schemes and budgeted credit subsidies for disadvanged groups will not be used except under exceptional circumstances where market failures are clearly indicated and more appropriate alternatives are not available to correct them. Interest rates charged to beneficiaries under special credit schemes/lines of credit will largely be based on prevailing market rates.

13. The initiatives in the above areas rest principally with the Government. However, banks will also need to take complementary actions. For example, they will need to diversify financial instruments aimed at customer services. Banks will also need to adopt appropriate measures to improve overall efficiency through rationalization of their branch networks (where necessary), improvements in their systems and procedures (in particular for internal controls and accounting, non-performing loans and other obligations), and staff training. The Government will provide supportive actions in these areas where appropriate.

14. The Government has supported the initiative to establish a discount house by the banks and insurance companies as an initial step towards the development of a money market. The gradual building up of its activities will be carefully planned in order to ensure a manageable and stable development, while ensuring that it has no undue exposure at the initial stages. In addition to bringing together into a single market those institutions with cash surpluses or deficits and thus promoting a more intensive use of cash balances in the economy, the discount house will allow demand and supply to determine short-term interest rates.

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15. The concept of establishing a capital market in Accra, probably through the Accra Securities Market (ASM), has ben fostered for some time by the fact that a growing demand exists for such services from potential investors and corporate issues. As it is necessary for the foundation of a capital market to be as secure as possible, the BOG will assess the demand for, and supply of quoted securities covering the primary and secondary markets. In order to instill confidence in both suppliers and users of long term debt and equity finance, the Government will support the development of both an adequate package of incentives, as well as a suitable regulatory and institutional framework to prevent financial abuse. In addition, the BOG with the assistance of IDA will assess the suitablility of a specialized institution providing venture and development capital.

Improved Mechanisms for Rural Finance

16. All banking institutions have a crucial role to play in rural finance. However, the efficient development of the rural banking system will form the backbone of the efforts to ensure appropriate support to agriculture and other rural pursuits. The focus of these efforts will be on supervision, strengthening their operational performance, and rationalizing and expanding the scope of the system. However, the system must be allowed to evolve at its own natural pace with the minimum of Government intervention but with the maximum of Government support. While the commercial banks will be encouraged to expand their rural branch network and local lending of deposits, this should not be at the expense of the efficiency of their overall operations.

17. A detailed review of the rural finàncial subsector including the rural banking system will be undertaken over the course of the next six months with the assistance of the World Bank and other multilateral/bilateral agencies. Detailed actions to deal specifically with rural financing issues will emerge from this review, particularly means of assuring the availability of finance for long gestation viable activities.

Outcome of the Program

18. The Government believes that the implementation of the action program will result in a sound, efficient and diversified financial system, capable of mobilizing both short and long term resources and allocating them efficiently. The financial system will be able to support and facilitate investment and production responses by the private sector to the on-going reforms under the structural adjustment process. A dynamic and responsive financial system will also permit more effective monetary management of the economy. However, it is recognized that reforms in the financial system will not in themselves lead to increased investment and production. The ongoing trade and incentive policy reforms under the Structural Adjustment Program (Being supported by an IDA Structural Adjustment Credit) are necessary to highlight growth opportunities, while parallel actions are required to ensure that the operating climate for enterprises does not hinder the conversion of these opportunities to investment and production decisions.

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Financial Reuirements of the Program

19. Preliminary estimates of the financial requirements to implement the principal aspects of the action program are in the order of US$325 million; this estimate will be revised as the detailed actions are firmed up and when the findings of the specific diagnostic studies have been reviewed. The amount will need to cover restructuring requirements of most of the commercial banks and development finance institutions, foreign exchange losses linked to lending by these institutions which have to be assumed by the Government and Bank of Ghana, as well as technical assistance, logistical support, instituion building and seed funding for venture capital. The Government will substantially contribute through appropriate financial means to the restructuring of distressed institutions; it is anticipated however, that a significant part of the restructuring requirements will be met through equity contributions by non-government parties.

20. In view of the initiatives taken by Ghana in the formulation and implementation of the Initial Action Program of reforms of the Financial system the Government requests your favourable consideration for the extension of a Financial Sector Adjustment Credit in the amount of at least US$100 million. The Government would also appreciate IDA's assistance in organizing cofinancing from other multilateral and bilateral sources to support the program.

Yours faithfully,

(DR. KWESI BOTCHWEY)
PNDC SECRETARY FOR FINANCE AND
ECONOMIC PLANNING

GHANA - FINANCIAL SECTOR ADJUSTMENT PROJECT

IMPLEMENTATION SCHEDULE FOR POLICY ACTIONS

Action	Party Responsible	Date of Implementation
I. MEASURES TO ENHANCE SOUNDNESS OF BANKING INSTITUTIONS		
A. PRUDENTIAL REGULATIONS		
1. (i) Establish a minimum capital adequacy ratio for prudential purposes; (ii) increase minimum amount of paid-up capital to establish a bank (to be revised from time-to-time by BOG); (iii) apply capital adequacy provisions to development finance institutions engaged in commercial banking; (iv) limit dividends by banks that do not meet capital adequacy guidelines; and (v) empower BOG to mandate greater capital for prudential purposes for individual banks on case-by-case basis.	BOG/MFEP	1-6 Agreement with IDA on draft legislation: July 1988 Enactment: February 1989 Implementation: December 1989
2. Require development finance institutions, where engaged in commercial banking, to provide for statutory reserves of at least the levels required of commercial banks.	BOG/MFEP	
3. Place limits on secured as well as unsecured loans to any single borrower (individual or enterprise). Place stricter limits on secured as well as unsecured loans to companies in which a bank's director has an interest exceeding a certain percentage.	BOG/MFEP	
4. Review and increase penalties for violation of banking regulations.	BOG/MFEP	
5. Require audited reports on banks submitted to BOG to be in long form format in accordance with other BOG guidelines, based substantially on international standards.	BOG/MFEP	

Action	Party Responsible	Date of Implementation
6. BOG to require banks to classify their portfolios according to criteria for substandard, doubtful, and loss assets (to be reported on a periodic basis, together with the specific provisions established). These standards to be developed with the assistance of an international accounting firm. Implementation of the full range of remedial actions to await the appointment of two technical advisors in bank supervision.	BOG/MFEP	6-7 (i) Appointment of two technical advisors in Bank supervision: March 1988 (ii) Recruitment of international accounting firm: March 1988 (iii) Agreement with IDA on guidelines and reporting requirements: July 1988 (iv) Review implementation programs: February 1989
7. Introduce improved reporting requirements from banks to the BOG, offsite analytical capabilities and indicators, as well as logistical support.	BOG	
8. Support establishment of a credit clearing house for banks.	BOG	Terms of reference and identification of consultant satisfactory to IDA: December 1988 Establish CCH: December 1989
B. BANKING SUPERVISION		
1. Enforce, through guidelines and monitoring action, internal controls and in-house audits of banks.	BOG	Part of restructuring of banks.
2. (i) Issue mandatory minimum terms of reference expanding scope of external audits of banks, (ii) hold periodic discussions between BOG and the auditors.		Agreement with IDA on draft banking regulations: July 1988 Issuance: February 1989 Implementation: December 1989
3. Strengthen examination methodology and skills. Review staffing needs of BOG's Examination Department, incentives and staff training, and set up a permanent training program for examiners.	BOG/MFEP	Drafting of Examination manual and preparation of training programs: February 1989
4. Establish computerized system for prudential returns from banks and analyze the financial situation of banks based on a set of performance indicators. Provide feedback to bankers.	BOG	Implementation prior to February 1989

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Action	Party Responsible	Date of Implementation
5. Draw up and implement an annual inspection plan, including full and targetted examinations (each bank to be visited at lease once a year).	BOG	Satisfactory review by IDA of implementation: February 1989
6. Repeat external audits of banks with assistance of international auditors.	BOG	Satisfactory review by IDA of implementation: February 1989
C. ACCOUNTING AND AUDITING		
1. Institute of Chartered Accountants (ICA) has agreed to be the focal point for efforts to upgrade and strengthen the accounting profession in Ghana.	BOG/ICA	Recruit technical assistance and initiate training program in agreement with IDA: February 1989
II. BANKING RESTRUCTURING		
1. Carry out full diagnostic studies by international auditing firms.	BOG	Completed
2. Implement safeguard measures to prevent further deterioration.	BOG	April/May 1988
3. Recruitment of an adviser on banking restructuring.	BOG	September 1988
4. Formulation of a framework and timetable satisfactory to IDA specifying the modalities for the restructuring of banks, in particular (i) measures for dealing with banks portfolio of non-performing loans, including loans to state-owned enterprises. (ii) rescheduling/conversion of Government's loans to banks.	BOG	February 1989
5. Agreement with IDA on specific proposals and targets for a reduction of banks' non-performing portfolio (including off-balance sheet items).	GOG/BOG	Agreement with IDA by October 1988 on a program for reduction of at least 50% by February 1989. Satisfactory review by IDA on progress of implementation and agreement on reduction of remainder: December 1989
6. Finalization of specific restructuring plans acceptable to IDA for commercial banks.	GOG/BOG/ Banks	Agreement with IDA on plans for commercial banks accounting for at least 50% of commercial banks assets February 1989— satisfactory review by IDA of implementation progress: December 1989

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Action	Party Responsible	Date of Implementation
		Agreement with IDA on plans for remaining commercial banks: December 1989
7. Finalization of specific plans acceptable to IDA for development banks.	GOG/BOG/ Banks	Agreement with IDA on plans for banks accounting for at least 66% of DFC's assets: February 1989. Satisfactory review by IDA on implementation progress: December 1989.
		Agreement with IDA on plans for remaining development banks: December 1989.
7. Undertake study on needs for corporate sector restructuring.	GOG/BOG/ Banks	Completion of study by February 1989 according to terms of reference agreed with IDA.
8. Carry out study on exchange risk protection.	BOG	Completion: February 1989
III. DEPOSIT MOBILIZATION AND CREDIT ALLOCATION		
A. DEPOSIT MOBILIZATION		
1. Review provisions in laws and regulations relating to disclosure of information.	PNDC	
2. Allow banks to set scale of charges; undertake survey of charges on a semi-annual basis and publish results.	BOG	Agreement with IDA on timetable for decontrol: February 1989
3. Amend regulations to permit banks to vary working days and business hours of branches.	BOG	Circular to be issued by July 1988
4. Review system for collecting and clearing cheques.		
5. Allow banks to set own interest differential on demand, savings, and time deposits.	BOG	Effective
6. Design and introduce package of measures to attract emigrants remittances.	BOG	Effective

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Action	Party Responsible	Date of Implementation
B. CREDIT ALLOCATION		
1. Allow banks to set their own interest rates on loans.	BOG	Effective
2. Discontinue sectoral credit targets.		Sectoral ceilings discontinued. Floor for lending to agriculture to be reviewed by December 1989 with a view to making appropriate revisions.
3. Establish mechanisms and criteria for determining use of special lines of credit and other special schemes to be used only in special circumstances.	BOG	Task force to be established by May 1988.
4. Review efficacy of Credit Guarantee Scheme.	BOG	Scheme to be reviewed in connection with forthcoming SME project. In the meantime scheme to remain dormant.
C. EFFICIENCY OF BANKING OPERATIONS		
1. Prepare and circulate standard set of average efficiency measures for banks.	BOG	December 1988
IV. MONEY AND CAPITAL MARKETS		
A. MONEY MARKET		
1. Determine modus operandi for Consolidated Discount House (CDH). Establish nature and extent of liquidity support by BOG. Identify prudential reporting and monitoring requirement of BOG. Define operational limits through acceptance by CDH and BOG of a CDH Statement of Operational Policies, to be developed with Technical Assistance.	CDH/BOG/GOG	Identification of consultants April/May 1988 Implementation of an action program agreed upon with IDA February 1989.
B. CAPITAL MARKET		
1. Conduct study of (a) investors (b) corporate issuers and (c) secondary trading to determine demand.	GOG/BOG	1-2 Study to be completed on the basis of terms of reference satisfactory to IDA prior to February 1989. No major Government initiative in capital market until results of study are available.
2. Review experience in other countries, possibly with IFC assistance, and make decision on applicability in Ghana.	GOG/BOG/GIC	
3. Discuss available incentives, review likely effects, and implement.	GOG/BOG/GIC	3-4 Implementation prior to December 1989

Action	Party Responsible	Date of Implementation
4. Develop with technical assistance, a suitable regulatory framework depending upon outcome of study (IV.B.1)	GOG/BOG	
5. Give financial and logistical support to Institute of Chartered Accountants (ICA) to review and upgrade auditing standards for corporate sector.	GOG/BOG	Recruitment of TA: February 1989 (see I.C.1)
6. Amend Social Security Decree Regulation to allow some of social funds generated to be invested in long-term securities of credity-worthy finance institutions and companies.	GOG/SSNIT	Implementation on basis of draft reviewed by IDA February 1989

GHANA

FINANCIAL SECTOR ADJUSTMENT CREDIT

THE STATUS OF BANK GROUP OPERATIONS IN GHANA

STATEMENT OF BANK LOANS AND IDA CREDITS (as of March 30, 1988)

Loan or Credit Number	Fiscal Year	Borrower	Purpose	Amount Less Cancellation	Undisbursed a/
				(US$ million)	
25 loans/credits fully disbursed				377.32	
Credits					
1082-GH	1980	Republic of Ghana	Volta Region Ag. Dev.	29.50	7.23
1170-GH	1981	Republic of Ghana	Railway Rehabilitation	29.00	1.74
1342-GH	1983	Republic of Ghana	Water Supply T.A.	13.00	2.51
1373-GH	1983	Republic of Ghana	Energy Project	11.00	6.16
1435-GH	1984	Republic of Ghana	Export Rehabilitation	40.12	1.40
F000-GH	1984	Republic of Ghana	Export Rehabilitation	35.00	7.73
1436-GH	1984	Republic of Ghana	Export Rehabilitation Technical Assistance	17.10	2.60
1446-GH	1984	Republic of Ghana	Petroleum Refinery Rehab. and Technical Assistance	6.90	1.46
1490-GH	1984	Republic of Ghana	Second Oil Palm	25.00	14.96
1564-GH	1985	Republic of Ghana	Accra District Rehab.	22.00	11.27
1573-GH	1985	Republic of Ghana	Second Reconstruction Imports Credit	60.00	10.60
1601-GH	1985	Republic of Ghana	Road Rehabilitation and Maintenance	40.00	21.72
1620-GH	1986	Republic of Ghana	Power System Rehabilitation	28.00	11.77
1652-GH	1986	Republic of Ghana	Health and Education Rehabilitation	15.00	11.10
1672-GH	1986	Republic of Ghana	Industrial Sector Adjustment Credit	20.50	0.46
A013-GH	1986	Republic of Ghana	Industrial Sector Adjustment Credit	24.95	6.42
1674-GH	1986	Republic of Ghana	Ports Rehabilitation	24.50	10.32
1744-GH	1987	Republic of Ghana	Education Sector Adjustment	34.50	23.29
1759-GH	1987	Republic of Ghana	Northern Grid Extension	6.30	4.40
1777-GH	1987	Republic of Ghana	Structural Adjustment Credit	34.00	23.50
A025-GH	1987	Republic of Ghana	Structural Adjustment Credit	60.09	35.44
A0251-GH	1987	Republic of Ghana	Structural Adjustment Credit	14.66	14.66
1779-GH	1987	Republic of Ghana	Structural Adjustment Institutional Support	10.00	9.09

a/ Calculated at the exchange rate applicable on March 30, 1988.

Loan or Credit Number	Fiscal Year	Borrower	Purpose	Amount Less Cancellation	Undisbursed a/
				(US$ million)	
1801-GH	1987	Republic of Ghana	Agricultural Services Rehabilitation	17.02	16.03
1819-GH	1987	Republic of Ghana	Petroleum Refinery and Distribution	15.00	15.00
1847-GH	1988	Republic of Ghana	Public Enterprise TA	10.50	9.05
1854-GH b/	1988	Republic of Ghana	Cocoa Rehabilitation	40.00	40.00
1859-GH b/	1988	Republic of Ghana	Transport Rehabilitation	58.87	58.87
1874-GH b/	1988	Republic of Ghana	Priority Works	10.00	10.00
Total number of credits = 29				783.59	408.04
			Total (not approved)	1,108.91	
			of which has been repaid	135.34	
			Total outstanding	1,025.57	
			Total undisbursed		408.04

a/ Calculated at the exchange rate applicable on March 30, 1988.
b/ Not yet effective as of March 30, 1988.

STATEMENT OF IFC INVESTMENTS
(as of March 30, 1988)

Investment No.	FY	Obligor	Business	Loan	Equity	Total
				US$ million		
777-GH	85	Ashanti Gold Field Corporation, Ghana Ltd.	Mining	27.5	-	27.5
914-GH	87	Keta Basin Oil	Oil Exploration	-	4.5	4.5
973-GH	88	Bogosu	Gold Mining	-	0.5	0.5
		Total Commitments		27.5	5.0	32.5
		Total Undisbursed		7.5	2.9	10.4

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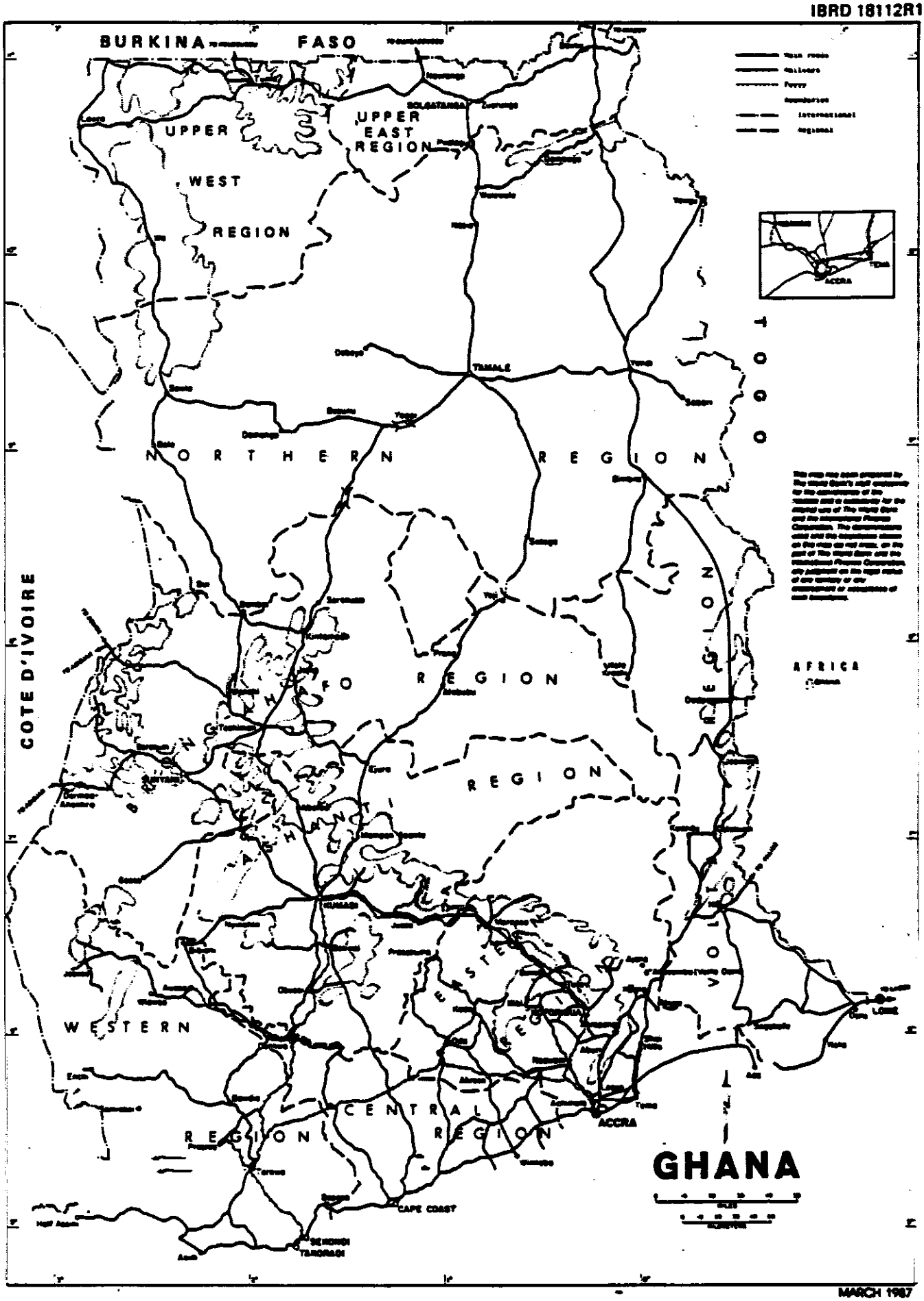
IBRD 18112R1



MARCH 1987

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Time and Money in the Western Sahel

The Cultural Economy of Interest and Usury in "Informal" Gambian Rural Finance[1]

Parker Shipton
Institute Associate
Harvard Institute for International Development
and
Assistant Professor
Department of Anthropology
Harvard University

Draft

Prepared for the USAID/IBRD/IMF Conference on Policy Reform and Financial Sector Research in Sub-Saharan Africa, The Sequoia Institute, Washington D.C., June 19-21, 1989

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Currency

6 Dalasis = U.S. $1

I. Introduction

When Benjamin Franklin wrote, "Remember that time is money" in his Advice to a Young Tradesman in 1748, he revealed starkly a cultural assumptions common to northern Europe and North America. He continued, "Remember that credit is money"... "Money can beget money", summing up a way of thinking that that Max Weber would identify a century and a half later as a hallmark of what he called the "Protestant ethic".[2] It is conventional in northern countries to conceive of interest charges on loans in terms of rates per unit of time, and to judge fair moneylending and usury in terms of such rates. So embedded is this way of thinking that savings banks advertize six percent interest, for instance, without needing to add that this is an annualized rate. Both borrower and lender take it for granted that the rate of interest to be paid in fact will depend on the time elapsed between the loan and repayment, or between the deposit and the withdrawal. They assume, moreover, that the interest rate is linear. Six percent after one year, twelve percent after two; nothing could be more natural. It is the rate, not the ratio of interest to principal, or just the amount finally paid, that determines whether the interest charge is fair or not.

Why might Franklin's young tradesman have "forgotten" that time is money? Does anyone think differently? Evidence from research in rural areas of The Gambia suggests that some in West Africa do, and that among farmers and traders there, calculation of interest as "rates" per unit of time is only one of a range of conventional modes of thought about it, and not the most common. Whether this mode or some other applies may depend on the borrowers' and lenders' identities, their relationship, their circumstances, and the forms the loan and repayment take, among other things. This contextual dimension can render conventional attempts to calculate "market rates" of interest meaningless.

The argument is not that rural Gambians cannot conceive of interest in terms of a linear rate, or that they never entertain such thoughts. Many can and do.[3] Nor, conversely, could one sensibly argue that American or English bank depositors pay no attention to the absolute amounts they gain or lose as interest charges, or to the ratios between principal and interest when they finally withdraw their savings or repay their loans. The findings suggest, rather, that the tendencies and the preferences of time-money construction can differ between one culture and another. These are not differences of mental capability, but of idiom and convention. British-based national moneylending laws in force in The Gambia are based on fundamentally different assumptions from the rules of Islamic law and custom that pervade the countryside. The differences are far more complex than "interest versus no interest"; and the overlaps of European, middle Eastern, and African cultural codes leave much room for local debate and uncertainty about what is correct behavior in rural

finance.

Gambian Rural Society and Economy

The Gambia, a former British colony and officially anglophone, is surrounded by Senegal (a former French colony and officially francophone) but for the short coastline on the western side. Essentially a narrow strip of land on both sides of the winding lower Gambia river, the country was affected by trade with Britain from the late 16th century, and heavy slaving up to the abolition in 1874. The country has a long and complex history of trade over long and short distances. The Gambia was hotly contested by European imperial powers during the early part of its British colonial rule (and intermittent company jurisdiction in the early years) from 1588 to its independence in 1965. Today, in a different way, a lively cross-border commerce of persons and things, legal and illegal, qualifies The Gambia's separate identity.

Ethnically, The Gambia has a rich mixture (in decreasing order) of Mandinko, Fula (or Peulh), Wollof, Jola, Serahuli (or Soninke), and other ethnic groups including Mauritanian Moorish and (now only urban) Lebanese trading minorities. Ethnic group distributions do not correspond closely with the country's administrative units (which, largest to smallest, are divisions, districts, and villages). The ethnic groups extend across the borders into Senegal, and some well beyond. Rural Gambians live in nucleated villages with fields surrounding. Many of the villages are multi-ethnic, though some have ethnically "purer" neighborhoods within them. Nearly all villages in the country are connected by some sort of road to the Gambia's two main highways. Each village has a headman and usually a woman who heads a women's or senior women's association. All or nearly all groups are strongly patrilineal, and villages tend to be endogamous. Broad age grades correspond with village associations and voluntary groups (kafo groups, in most Gambian languages). Most Gambian ethnic groups are also notable for endogamous castes (e.g. alkalo or headman, imam or religious leader, metalworker, woodworker, leatherworker, and "slave"); but while these order marriage and some other social relations, they do not usually correspond very closely with actual occupation and livelihood.

The country's roughly 751,000 people (1985), about 80% of them now rural at any time, live in an area of 4,361 square miles (somewhat smaller than Connecticut), at a density of about 172 per square mile over-all. Rural land shortage is just now becoming a concern as farmers grow their grains (millet, sorghum, maize), their groundnuts, sometimes their rice, and other crops with new tools including ox-ploughs; as livestock grazing challenges the country's sparse woodlands; and as soil quality, never very high, deteriorates. The country relies on a single rainy season, usually from June to October, and on seasonal migrant laborers ("strange farmers") from Senegal, Mali, Guinea. The Gambia supplements its domestic production with imported rice, some issued by government and private international agencies as relief aid.

By international development agencies' standards, including per capita GNP, The Gambia is one of the poorest countries in Africa and one of the dozen

poorest in the world. This remains so despite a dramatic economic reform program in the 1980s, a liberalization and structural adjustment program designed and implemented by the Ministry of Finance, the IMF, and the World Bank, that is generally acknowledged to have stimulated trade and at least some kinds of productive investment. The country remains heavily dependent on its main agriculture export crop, groundnuts, on fish, and on its entrepot trade for its foreign exchange; and it imports rice, some as foreign aid, to supplement its own production of that rural staple and millet and maize.

Formal Financial Institutions and their Relevance[4]

Rural institutional finance in The Gambia revolves around the groundnut trade, reflecting the main foreign interests in Gambian farming.[5] Several large international and domestic trading firms operate in the capital Banjul, and (decreasingly in recent years) in the countryside.[6] Over the past two decades, state-controlled producer cooperatives for input supply and marketing, under the Banjul-based Gambia Co-operatives Union (GCU), have practically displaced them in the groundnut trade and related lending to farmers, becoming ubiquitous in the countryside with up to 86 primary-level societies ("seccos") in the late 1980s. These units cover areas not based on any indigenous social entities, being larger than villages but smaller than districts. Repayment rates are poor and the co-operatives consistently lose the government money. The cooperatives' mushrooming has been an issue hotly debated by foreign aid agents, many of whom now consider their workings corrupt and inefficient; the World Bank and IMF have recently been trying to "re-liberalize" the country's groundnut trade by policy measures and stricter financial controls on the co-ops, resulting in the recent closure of about a third of the primary societies. The co-operatives are instructed to charge an annual interest rate of 26% for co-operative loans issued in cash or kind (1987), a positive real rate (inflation is about 10%) but not one high enough to keep the cooperatives solvent. This is a lower rate than private traders normally offer, though few farmers know the figure and many doubt the honesty of the weighers and clerks (as with the private groundnut traders). Some men borrow from the co-operatives and re-lend to their wives or foreign migrant share tenants; and some add their own interest charges, even for their wives. Farmers are ambivalent about the co-operatives: while they mistrust them they none the less feel dependent on them.

Banks are insignificant in their coverage, reaching under 4% of rural Gambian adults, and probably under 1% of the women. They include two commercial banks: the British-run Standard Bank and the government-owned Gambia Commercial and Development Bank; and the post office savings bank. All the institutions have interest policies based on annual rates, regulated by the Central Bank of The Gambia: in 1987, 22%-29% for bank loans; 15% for commercial bank savings and 15% for post office savings. Few farmers, and almost none of the women, know these rates. To most rural Gambians, all these institutions remain rather exotic, and most, particularly the banks, are not fully trusted.

Quickly entering the picture now, with a well-established local

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foundation of good will, are several foreign-based private voluntary organizations, including Action Aid, Catholic Relief Services, Freedom from Hunger Campaign, and Save the Children. All are trying to turn away from "relief" toward "development" efforts, especially in the small enterprise field. Most are experimenting with credit and, to a lesser extent, savings. The indigenously run but foreign-sponsored Gambia Women's Finance Company is trying to organize banking facilities for women, as are a few other small indigenous and exogenous groups.

The expertise of the banks in money management and the good will and trust of the private voluntary organizations have yet to be allied. Until they are, rural Gambians will prefer to organize their own systems of saving and credit. What are they?

II. Local Savings and the "Illiquidity Preference"

Gambians save most of their wealth in non-monetary forms, a point foreigners are apt to misunderstand.[7] It takes the forms of livestock (large stock are particularly important for men), and expandable gold earrings and other jewelry (particularly important for women). These are forms of wealth the sexes use to safeguard it from each other's daily demands, among other things. Savings also take the forms of stored crops, farm machinery, household furniture, radios, and other goods likely to be resold in rural villages. The main saving strategy of rural Gambians is to remove wealth from the form of liquid cash.

Cattle, donkeys and horses for men, and sheep and goats for men, women and children are preferred partly for the reason that they breed.[8] Time is livestock, perhaps more than it is money; and the Qur'an does not forbid this kind of "interest".

Gambian farmers who sell food crops tend to do so just after harvest. They recognize that withholding crop sales until later in the year, when food becomes scarce and prices rise, can yield them more cash. But few feel they can afford to wait. One reason is that losses in storage can be considerable. Another is that the demands of needy relatives become stronger in the "hungry season", and saving one's crops then for sale may appear anti-social: while maximizing short-term profits, one risks losing a social support network that may have longer-term economic value. The few who can afford to withhold or buy crops at harvest time, and are willing to risk some social disfavor for doing so, may serve as a kind of "pawnbrokers" for other farmers, selling them back similar foods later in the season at higher prices.

To the extent that cash is saved, it is saved mainly by "informal" means within villages. These are many. Among the simplest is the kondem ("condemned") box (or kondaneh, from the French condamné), which rural people will pay five or six dalasis (or just under a U.S. dollar) for a carpenter to

construct, with a small slot. The box must be broken to be opened, rather like a western "piggy bank".

Another widely-used strategy that suggests illiquidity preference is the money-keeper.[9] Some rural Gambians give money to others in their villages to hold for them. They may choose any trusted person -- there are no specialized deposit-takers -- but often the depositor will choose a close relative or a shopkeeper or other person who is likely to have other cash available for his or her own urgent needs. In a preliminary count on the villages surveyed, about 34% of the men and women interviewed had deposited money with other individuals at some time within the previous twelve months. Nearly all of these chose people living within their villages. About 7% had kept money for others during the same period. A few of the individuals named as depositors or deposit-takers, however, were spouses of the informants, so not all of this is inter-household depositing. Sums deposited ranged from 25 to 2,000 dalasis; but over 80% of the deposits were below 500. Some 95% of the deposits were for periods of less than one year; most were for no longer than 3 months.

Interest payments or service charges are unheard of in this money-keeping, and the depositor often expects to receive back the same notes or coins lent. Both men and women take deposits. An individual may hold money for several people simultaneously, and occasionally an individual deposits with more than one keeper at a time. It is generally agreed that the money-keeper should not use the money deposited, but it is not so clear who holds the legal right to the money during the period of the deposit.[10]

A related way of saving, for wage earners, is to ask employers to withhold wages over short times to let them accumulate. Some agricultural wage laborers prefer to be paid only quarterly, and a recent study of Gambian share contracting in farming found that most workers prefer arrangements in which they receive their main compensation seasonally rather than at shorter intervals (Robertson 1987: 221).

Women, in towns and in increasingly in the rural villages, form rotating savings and credit associations (or ROSCAS, also called <u>tontines</u>, merry-go-rounds, or in The Gambia, <u>compin</u> ["company"] groups) to mobilize savings for personal or household purchases.[11] In each of a series of regularly scheduled meetings, all members contribute a fixed amount and one takes home the lot. Among the many advantages of this system are that they allow members to save without appearing anti-social -- a critical function, since Gambian normally have many needy and demanding relatives and neighbors all around.[12] Another is that they keep the money in circulation in a community. "Time is money" here acquires a new meaning. Whereas banks require rural people to forfeit temporarily the use of their deposited money (except for the smaller part re-circulated in loans), ROSCAS keep it usable in locals' hands throughout. Villagers save their time with the money.

All these local savings mechanisms in The Gambia are interest free. Indeed, when inflation (now about 10%) is taken into account, nearly all represent <u>negative real interest</u>.[13] So Gambians are willing to pay to remove their cash from their own individual hands: further evidence of <u>illiquidity preference</u>. Time erodes money, and it erodes it most quickly in one's own

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pocket.

Amounts Commonly Saved

It is nearly impossible to determine the amounts of farmers' personal cash savings. Indirect questioning in the villages suggested that most farmers' cash savings could be counted in the hundreds of dalasis (sometimes held partly in francs CFA) at any given point during the "trade season" from December to March, a few farmers' rising into the thousands; but that most have cash savings of less than 100 dalasis at any given time during the rest of the year. Men appear generally to have larger sums at their disposal than women have during the trade season, but women seem usually to save more than men, as a proportion of their wealth and perhaps also in absolute sums, in the lean season.

Problems with Banking

Obviously, the large majority of Gambians who save their cash at home or with money-keepers forego the interest they might earn in banks or other financial institutions (now 15%). Few farmers without major off-farm incomes use the formal banking system.[14] Outside Banjul and nearby Serrekunda and Bakao, commercial bank branches are found only in Farafeni and Basse. A 1975-6 survey of rural Gambian villages found that only two (2%) of 94 informants had bank savings (Dunsmore et al. 1976: 307). In the present study, four (3%) of 138 male and female informants stated they had deposits in commercial banks; four others, again 3%, said they had money in post office savings. Only one of 69 women interviewed had a savings account in either a bank or post office savings. Branch bank information confirmed that most farmer depositors hold amounts below about 250 dalasis, that very few of them are women, and that almost no farmers borrow from banks.[15]

When asked about their reasons for not using banks, farmers in the villages surveyed cited several: distance, inconvenient opening schedules, requirements of minimum deposits, difficult paperwork, and distrust of clerks.[16] Some cited with bitterness their recent experience with the Agricultural Development Bank, which had taken deposits in the early 1980s and ceased operating without refunding them. A few, including Mauritanian shopkeepers, stated that they did not bank because to do so would be to charge interest, an act discouraged in Islam. However, since some of these merchants do charge interest in informal lending, this answer should probably not be taken at face value.

Though few use banks now, most farmers interviewed responded quite positively to the idea of mobile banks, saying they would like to see these tried, or tried again, in their areas.[17] A problem to be surmounted in mobile banking in areas dependent on rainfed agriculture, as in most of The Gambia, is that a bank has stronger financial incentives to make the rounds in the "trade season", when farmers have significant sums of money to deposit, than

during the rest of the year, when farmers are more interested in withdrawals. But clearly, inaccessibility has been a major barrier to institutional savings.

Here, "time is money" acquires yet another meaning. Whether in the "trade season", when they would be most likely to deposit, or in the hungry season that is also the busy weeding season, when they would be most likely to withdraw, time is valuable. The time taken to obtain identification photos, to travel to the banks, to wait for them to open, to queue, and to wait for countersignatures all carries opportunity costs for rural people living far away from banks.

III. Sources of Informal Credit

Gambians do not share the Euro-American concept of "loan" as a single idea spanning all types of exchanges for a delayed consideration. In the Mandinka language, for instance, there is a sharp division between furo, to make a helping loan of, say, tools or clothes, to be returned in a few days; and, on the other hand, ndontoro, to make a business loan, normally longer-term and carrying an interest charge. How much of the rural economy takes the form of "loans" or "credit" -- 20%, 40%, or 80% -- depends on how one asks the questions, and in how many different ways.

A Usual First Choice: Kin

It is to relatives that farmers or small businesspeople turn first when they wish to borrow. The reasons farmers most often cite for choosing kin as lenders are that (a) they are nearby, (b) it is easier to persuade them to lend than non-kin, (c) they are less likely to charge interest, and (d) they are more likely to be lenient in the event of difficulties in repayment. From the lenders' perspective, the picture is not quite so simple. Kin may be especially trustworthy borrowers because there may be many social sanctions the lenders can bring to bear for repayment. Felt moral obligations make these borrowers likely to take care of machinery, livestock, or other damageables lent. But some lenders prefer to avoid lending to kin precisely because having to pursue them for repayment would seem anti-social.

Kin are used for loans of all kinds of goods and services. Their proximity in many cases makes them convenient sources of land and of goods hard to transport, like bulky foods, but farmers commonly borrow cash, seeds, labor, and other factors of production from their relatives. Fertilizers are likely to be lent from husbands to wives, to the extent they are lent informally at all. It is from kin that farmers take many of their smaller loans: a few dalasis may change hands in a family several times a day. But the

biggest loans are also likely to come from relatives.

The matter of interest payments is particularly important. As Haswell observed in Genieri village, "Where a man borrows from another with whom he has kinship ties, the loan is usually interest free" (1976: 124n.).[18] Not for everyone, however: as noted above, transactions between spouses sometimes involve interest charges.

Men lend to both men and women; and women, though they lend less than men, will also lend to either sex. There seem, however, to be preferences for borrowing from members of one's own sex.

Extended family members sometimes lend large amounts of money -- thousands of dalasis -- to a promising young man to send him abroad for schooling, work, or both. They must sometimes sell significant parts of their herds to do so, and they contribute on the understanding that he will send back money. In the villages visited, young men had travelled and worked in Spain, northern Europe, America and elsewhere for varying amounts of time. Remittances were impossible to measure, but some had sent as much as 7,000 dalasis to their families at a time, and in some villages several of the largest houses with purchased materials had been financed this way. A young man with wage-earning potential represents for many farming families the main chance for advancement, and for many young men who travel to find work, debts to their sponsors may be the greatest they ever incur. It is not customary to send women abroad to find work, partly because of Islamic traditions.

The patrilineal, virilocal kinship systems operating in all parts of The Gambia ensure that men and unmarried women normally have a number of relatives resident in their villages; and moreover, the tendency for marriage to occur between nearby villages creates a web of affinal kinship for both men and women in their regions.[19] Because they stay in their original homes after marriage, men usually have more options locally available for loans than married women.

Savings and Debts Involved in Marriage

Marriage entails some of the largest savings and debts that rural Gambians accumulate in their lives. Throughout the country, payments of bridewealth (locally called "dowry") from the family of the groom to the family of the bride are customary.[20] These payments are usually only paid gradually after a marriage is begun. The payments may take a decade or more to complete.

In the wife's family, meanwhile, substantial savings have occurred that may have taken years to accumulate, for earrings and other jewelry to be given to her upon the marriage. This saving is usually the responsibility of her mother; and for many women, these ornaments (often made of gold and costing D. 1,000 or more) require the largest cash savings

they make. Women also commonly resort to their kafo groups (see below) or other local associations for loans or contributions on these occasions.

The great importance of marriage debts, financially, culturally, and emotionally, may be a useful explanation for non-repayments in institutional lending. In-laws are likely to be considered the "creditors" with the strongest claim to a family's resources. This does not imply, however, that the Government should try to regulate marriage payments. Most attempts to do so in Africa have totally failed and only caused public resentments.

Second Best: Unrelated Friends and Neighbors

The types of lending that occur between unrelated friends and neighbors are much the same as those occurring between kin --an enormous variety of goods and services, on widely varying repayment schedules. But between these borrowers and lenders, small interest charges may be made -- often about five to ten percent over six months -- though these arrangements too will vary greatly.

Where there are no kinship ties to invoke, loan seekers will usually lean on village ties and other kinds of social commonality.[21] One is age: the Gambian systems of age-grades and age-sets (described in Dunsmore et al. 1976: 278-9) provide each Gambian with a recognized sets of peers for life. Another is caste (or inherited occupational class): though officially disapproved, these distinctions continue to structure informal economic alliances at the village and intervillage levels. School ties and other associational memberships are likely to be called into play. Ethnicity too will of course come into consideration, though the ethnic determinants of economic co-operation or rivalry appear less strong in The Gambia than in many other African countries.

For the lenders, usually the motives for lending boil down to social solidarity and the preservation of a relationship for future purposes, but there may be other motives such as unloading the risks of cash or commodity storage to the lender.

Among friends and neighbors, and among kin, no guarantees or collaterals are used to secure loans. Usually the only sanction available for ensuring repayment is the threat of refusal of further loans or other favors. In cases of crop failures, lenders related to or friendly with their borrowers appear often simply to cancel the debts.

Relatives and friends who happen to be shopkeepers or other merchants make particularly useful sources of credit, for they are likely to have more cash and consumable goods at their disposal than others.

In The Gambia, land, labor, livestock, and farm implements are all directly exchangeable for each other at local levels by an infinity of ad hoc, unnamed, and individually tailored arrangements, many of which take the form of short-term loans and counter-loans. Most often, these occur

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between close neighbors, who may also be close kin. But agricultural exchange partnerships also occur between seasonal migrants and their hosts: land and lodging are given in exchange for labor, the details varying according to farmers' and migrants' circumstances.[22]

Harder Bargains: Local Shopkeepers and Other Merchants

It is usually only in the absence of other kin, friends, or neighbors with disposable assets that farmers or other rural people will turn to unrelated merchants (in Mandinka, juloo; in Fula and Wolof, julaba) for loans. The reason is the terms these are likely to offer. Interest charges are much more likely to be imposed, and will probably be higher. Shopkeepers are more likely to make special demands about the form of a loan or its repayment than relatives or friends. Repayment periods may be shorter, and there is a danger of legal prosecution in the case of default. But their possession of liquid capital makes traders an important source of credit for rural people throughout the country.

While the major lending merchants in the villages and small towns are usually shopkeepers, there are also many small-scale and seasonal traders who operate from their houses without special shops. Many rural shopkeepers are engaged in several kinds of businesses simultaneously, while also being farmers. The Gambia does not have specialized local moneylenders such as are found in parts of southern Asia.[23]

Nearly all lending by merchants appears to be demand-driven: it is not customary for merchants with lendable resources to solicit borrowers openly. (Groundnut-buying agents may, however, be exceptional in this respect; when they receive loans from urban groundnut traders for re-lending to farmers they will let it be known that there is money available.)

Traders will usually lend either money or the goods they sell. Among the commodities lent by merchants interviewed (a sample of only a few) are rice, sugar, coarse grains, cooking oil, and durable household goods.

The role of traders in providing agricultural inputs for cash or credit is now more or less limited to a part of the nation's seed provision (see below). In the villages visited, no evidence was learned of any traders currently supplying fertilizer, the co-operatives now being the sole channel available to villagers. This situation appears to be the result of government price subsidies and other policies that have strongly favored the co-operatives in recent years. Nor do private traders lend agricultural implements like ploughs, sine hoes, or heavier machines.

The durations of loans that merchants issue vary from a few hours to a year, or very occasionally longer. The largest loans these lenders offer are expected to be repaid at the time of the main harvest of groundnuts around December.

In choosing a merchant for a loan, the farmer will usually rely on the same kinds of principles used in choosing a friend or neighbor: depth of acquaintance and ties of ethnicity, age, etc. Some immigrant groups in the Gambia (notably the roughly 1,800 Mauritanians) and Gambian minorities (notably Serahuli, and increasingly Fula in the eastern divisions) have established reputations as rural merchants.[24] Some of these groups are endogamous, whether by choice or default. But shopkeepers appear at least as often to come from the majority groups of their villages or towns, as from minorities (see Weil 1977: 14).

In seeking loans, farmers will usually try first the shopkeepers or traders of their own ethnic groups who are solvent enough, and they seem often to bear in mind a rough order of ethnic preference for others as options. Relations between local majoritarians and minority traders are complex. Farmers depend heavily on these men for capital and goods in times of need.[25] Many have friends if not also relatives among the traders, and of course it is in the interest of the traders to stay on good terms with local villagers. But at the same time local farmers often resent traders for their wealth and consider them remiss for not sharing it more freely with their neighbors. (see also Haswell 1975: 188-9). Mauritanians, who tend to return periodically to their home country, are generally resented by Gambians for expatriating profits. As among immigrant trading groups in other parts of the world, these resentments on the part of majoritarians have fostered an attitude of separateness in circular fashion, to the point where minority traders seldom lend to members of the majority to set up businesses that might compete with their own, and the minority traders seldom receive governmental or other official financial help for setting up or expanding their enterprises.

In the farm villages visited it seemed to be mainly the poorer members who borrowed from shopkeepers; the richest appeared not to take any substantial loans from them (see also Haswell 1975: 65-6 for a similar report). This may suggest three things: (a) that better-off farmers are able to satisfy their main credit needs with loans from kin and neighbors and from co-operatives and other financial institutions, (b) that a principle of adverse selection forces poorer borrowers to borrow from less desirable lenders, and perhaps (c) that the interest rates of these lenders tend conversely to impoverish their borrowers.

There is evidence that the lending activities of private merchants expand during the years following poor harvests (Haswell 1975: 65-6). This too suggests that merchants are a disfavored (if valuable) credit source to which farmers are forced in hard times. However, local merchants do not just lend the obvious necessities for life; occasionally they may also lend fancier consumer goods.

Village and town merchants commonly lend not only to members of their communities, but also to those of others nearby. Neighboring villages are likely to have kinship and other ties that may be invoked for loan recovery.

But village and town merchants who lend to farmers normally lend only to

those they know personally. For those with whom they are on good terms, loans may be issued without written agreements, though literate merchants do keep records of loans issued. Borrowers not closely acquainted with the merchants use go-betweens whom the latter know and trust; the merchants can count on these men or women to serve as pressure-points in the case of a default. Alternatively, they may be used as direct financial intermediaries. In cases where borrowers and lenders are only distantly acquainted, or the amounts are large, the lenders may insist on witnesses or written agreements. Collaterals or loan guarantees are not normally taken.

Local merchants do most of their loan collection personally, by visiting their debtors or waiting until these visit their shops or workplaces. Like kin and neighbors, merchants wield the threat of refusing future loans in the case of a default. They also may rely on personal and social pressures: in The Gambia it is considered a great dishonor to one's family to be visibly pursued by creditors. In cases of obvious hardship, as when the borrower's pledged crop fails, merchants and other local lenders normally defer collection until the following harvest season, with or without charging further accrued interest.

Where personal and social pressures fail, merchant creditors frequently resort to local legal authorities to back up their claims. An examination of district and divisional court records in the Upper River Division revealed debt cases to be one of the most common kinds of cases arising in civil law (others being divorce and bridewealth cases). In debt cases the courts usually rule in favor of the creditors for recovery of principal, though they do not knowingly uphold substantial interest charges. Lenders who charge high interest rates but wish to sue defaulters in court must weigh the risk of being exposed and stigmatized as usurers.

Default rates on merchant loans are hard to gauge -- and the present sample is too small for a reliable figure anyway -- but a few shopkeepers interviewed suggested that about 10 percent of their loans were ultimately non-recoverable. This is probably a lower rate than in the case of loans between kin and neighbors, where there is likely to be easier forgiveness in cases of crop failures or other hardships. For merchants as for kin or neighbors, however, loans not repaid after two or three years are normally left as dead. This is, incidentally, what the Qur'an instructs lenders to do -- a point which may bear also on institutional lenders.[26]

In the villages visited there was no evidence that resources borrowed from local merchants were re-lent to third parties at higher interest.[27] This suggests that nearly anyone can borrow from a merchant at some rate of interest, and that merchants may be obtaining interest rates close to what the market will bear. Interest rates are discussed in a separate section below.

Other Individuals Who Lend Locally

At the village and intervillage levels, political and religious

leaders serve as redistribution points for community wealth. Notable are the village headman (alkalo), an elected member who may occupy his office for life; the leader (imam) of the village mosque; and any local marabout or holy man with a reputation. All of these receive contributions of food, and sometimes labor, from farmers in their communities, or in the case of marabouts, from followers who may come from far away. These contributions may take the form of a 10% share of harvest or income, prescribed in Islamic custom; it is customary for the payments to be made in coarse grains. Headmen and holy men are expected in turn to provide food to visitors and needy locals, in the forms of loans or alms as requested. They may also lend tools, and the village headman may lend land to locals or immigrants on behalf of the village.

Private Groundnut Traders as Lenders

Private groundnut traders are operating in competition with the state-controlled co-operatives in lending to farmers and marketing their groundnuts. In recent years the private traders (including the licensed "agents" and their sub-agents who re-lend to and buy from farmers on their behalf, and "buyers", who deal directly with farmers) have been losing. The Groundnut Produce Marketing Board (GPMB) reports that the private traders' share of declared groundnut tonnage purchased fell from 84% in 1962/3 to 57% in 1971/2 (GPMB Annual Report, 1971/2), and again from 61% 1975/6 to 19% in 1985/6.[28] Between 1964/5 and 1986/7, the number of private licensed buying "agents" dropped from seven to only two. (In 1981/2, 16 smaller-scale licensed "buyers" were appointed, but many of these have since stopped trading). These changes are largely attributable to government allowance and loan discounting policies favoring the Gambia Cooperatives Union (GCU).[29] Apparently little credit occurs in the lively cross-border groundnut trade.

The rising numbers of co-operative seccos (buying stations) in the rural areas -- there are now 86 -- seems to have contributed to a reduction of lending by private groundnut traders. This is partly because it has become easier for some farmers who borrow from the traders to sell their groundnuts to the GCU and thus default on their loans. This has not been a clear-cut change, however, since Gambian farmers have always had opportunities to sell their groundnuts informally in Senegal.

The incidence of farmers' borrowing from private groundnut agents or groundnut traders appears to vary substantially by village. Traders lend only where they have developed strong personal contacts, and they favor the farmers they feel are most likely to succeed. Some foreigners and Gambians cultivating seasonally as "strange farmers" rely on private traders for credit, since they are ineligible for membership in the co-operatives and may have only limited networks of kin and friends in their Gambian villages to rely upon for help. But "strange farmers" not fortunate enough to have close acquaintances with traders may have to borrow indirectly through their hosts, just as they sometimes borrow indirectly from the co-operatives.

Private groundnut traders finance purchases by borrowing from the commercial banks if they can, mortgaging land or other property. Some purchase from farmers on credit; farmers reported having waited up to about a week for some private buyers to pay for the crops. The competition provided by the co-operatives gives private traders incentives to pay farmers promptly.

Small Business Credit

Merchants lend to other merchants. A usual way of starting up a retailing business is to borrow cash or merchandise from a relative with a business of his or her own. This pattern obtains among Mauritanians and other foreigners in The Gambia, as well as among Gambians. Many of the smallest-scale businesspeople finance their operating costs through very short-term loans from larger merchants. Women producing fried foods for sale in local towns or marketplaces, for instance, receive sugar daily on credit from small shopkeepers.

On a larger scale, wholesalers and retailers in the provincial towns also borrow merchandise from large Banjul wholesalers, sometimes indirectly through the rural agents of these large merchants. Rice and sugar appear to be the commodities lent in largest volumes; a large provincial trader may take several hundred sacks per year on credit, though this might be only a small part of his turnover. These credit arrangements are usually made on the basis of long-term acquaintance and customer loyalty, if not also kinship; trust is essential. As retailing businesses in The Gambia are for the most part relatively unspecialized and highly competitive at local levels, retail mark-ups are frequently limited to a few percentage points (though turnover may be high). The rates of interest that urban wholesalers demand from provincial traders are correspondingly low: often about 5-10% over 6 months or 10-20% per year.[30]

It should be noted parenthetically that institutional credit has been far less important than informal credit in the establishment of small businesses. The government does have an agency for the purpose, however, and private voluntary organizations, however, are now entering this field.[31]

Interest Charges in Informal Credit

To foreign observers, the rates of interest that private rural lenders in West Africa charge often appear extortionate, and those found in The Gambia are no exception. Gambian merchants and other rural lenders commonly charge interest of 50-150% over 6-8 months, but rates vary enormously outside this range.[32] The wide variation may result in part from the secrecy surrounding interest charges. Not only is it common for researchers to receive inaccurate reports, but there are also uncertainties and disagreements in the rural population itself as to what rates are "conventional".

Before judging the appropriateness or fairness of the seemingly high charges, many factors must be taken into account:

1. Inflation rates. A loan at 5% interest in a year of 10% inflation is a loan with a negative real rate of interest.

2. The likelihood of default. A lender who lends at 20% interest to borrowers whose probability of default is 10% can count on only an 8% nominal profit. High interest may be considered in part a risk premium.

3. The opportunity costs of capital. Are there more profitable uses, like shop re-stocking, to which the lender might alternatively put the resources?

4. Administration costs and overhead. How much time and money will the lender spend pursuing borrowers in arrears, or checking produce received as repayments?

5. Seasonality: a sack of groundnuts lent as seed during planting time or as food during the hungry season is worth more in the rural community, in terms of either use value or exchange value, than a sack of equivalent weight in January just after harvest.

A way of testing whether merchants are charging profits higher than necessary would be to provide institutional competition at comparable rates. But the co-operatives, and other institutions with many local branches in The Gambia have been charging interest at subsidized and sometimes negative real rates, and many private lenders have responded by simply ceasing to lend in competition with them.

Ambivalence about Credit and Creditors

Credit is an indispensable part of Gambian rural life, but also, where the terms are harsh enough, a resented form of dependence. A common Mandinka term for a small-scale trader or for a loan, juloo, also means rope, and Gambians speak of having debts tied around their necks with well-understood connotations of slavery. The hostility behind the violent recent expulsions of Arabic-speaking Mauritanian traders from Senegal (and the reported emigrations of some from The Gambia) is based partly on lending terms that many locals have deemed exploitative while they have frequently depended on the credit to override seasonal or personal hardships. (Many Mauritanians, in turn, have depended on the repayment and the interest to maintain their families in their barren homeland by remittances). Credit is debt. It is a two-edged sword, and it cuts most sharply between near strangers.

Summary

This discussion of rural lenders has suggested that their lending terms depend on the social distance between them and their borrowers, and on a variety of other circumstantial factors. The secretive nature of informal borrowing and lending in The Gambia, and the variability of the terms on which it occurs -- in interest charges, repayment schedules, etc. -- mean that rural credit cannot easily be described as a "market" in the conventional sense of the word, with free information and readily identifiable prices based on supply and demand. Nor can the terms of lending, even at rates over 100% per annum, be summarily labelled fair or unfair. In the following pages we look examine some international influences on informal rural credit, considering first the role of Islamic law and then the role of colonially imposed British law. The relation of time and money in in interest charges appears in these pages as a focal point of cultural clashes and misunderstandings.

IV. Islam and Rural Financial Custom

Islam in Gambian Economic life

Some 85-95 percent of Gambians now participate at least nominally in Islam, which, since its appearance in the country in the 14th or 15th centuries has waxed and waned at times in influence, affecting not just on religious belief but on culture and economy more broadly.[33] The Qadiri and Tijani sects of Islam found locally also affect large parts of several neighboring countries, including Senegal. Most Gambians and seasonal immigrants combine Islamic with religious and social practice and belief.[34] But Muslims in The Gambia, as elsewhere, like to conceive of their religion as influencing all aspects of life, rather than as being confined to particular times, places, or activities. Scriptural and oral Islamic teaching has something to say about trading, saving, spending, sharing, borrowing, lending, and investing; and many aspects of these activities are encoded in the *sharī'a*, the sacred Law of Islam embodying ethical rules. Law, economics, and religion are so deeply intertwined in Islamic life that they cannot be understood separately. The sacred and secular merge.

Every Gambian village has one or more Muslim *imams* (mosque and prayer leaders), who may serve at times as public moral counsellors on practical matters of many kinds and as redistributive nodes of charities. Some also have *marabouts* (roughly, mystic holy men, counterparts in some ways to Sufis in the Middle East) who may variously combine Islamic and local religious traditions.[35] Some *marabouts* are major players in local economic affairs, though the Gambian ones tend not to be organized into politically powerful brotherhoods like some Senegalese ones. Gambians tend to practice alms-giving (*zakāt* in Arabic, *jako* in Mandinka), fasting, and feasting and ceremony as prescribed by the Qur'an and scriptural exegesis, sometimes with their own modifications. Arabian countries have financed aid projects providing many Gambian villages with wells, mosques, and other constructions. Local branches of pan-African and pan-Arab educational and social institutions provide scholarships for study abroad and help organize pilgrimages to Mecca. Islam influences local financial matters profoundly across the country. So does the Arabic language taught along with it in local Qur'an schools. Probably more Gambians can read and write Arabic than English or their own tongues. Written records of loan transactions, where they exist, are as likely to be kept in Arabic as in English. It is in Arabic, as seen below, that some of the most important concepts in financial life are expressed.

Interest Rates and Ratios: When Time is Money and When Not

Some Gambian practices and concepts concerning interest charges differ

radically from those familiar to many foreign financiers, and the failure of outsiders to take account of the differences is a source of major misunderstandings.

It is impossible to understand rural Gambian rural credit and savings without noting a few basic tenets of Islamic law and custom. As noted above, the vast majority of Gambians are at least nominally Muslims, and Qur'anic interpretations have profoundly influenced both financial systems and the legal systems that back them up.

The Qur'an explicitly forbids usury, repeatedly promising damnation for who practice it (though it condones profitable trade).[36] Like other Muslims from West Africa to Indonesia, Gambians refer to usury by the Arabic term ribā, meaning unjustified enrichment, or consumption at the expense of others for no good reason.[37] Many consider ribā a sin second only to murder.[38] "Dirty money" from ribā (in Mandinka, kodi jawo, bad money, or haaramoo, forbidden or ill-gotten gains) may not be used for pilgrimages to Mecca, for charities or religious feasts, for funerals, or for other holy expenditures.[39] Nor does ribā refer only to money; interest-bearing loans in kind are also sinful. These rewards are dangerous.[40]

To many Gambian Muslims who interpret holy scripture strictly, the prohibition refers to any charges that could be considered interest. To others, usury simply means any interest charges they deem unfairly high. The key term that recurs in the scriptures is "doubling". There is much debate in The Gambia about whether the prohibition is absolute or leaves scope for lesser charges. Many Gambians will say that even 1% profit earned by loan interest is more sinful than 100% earned by trade.[41] But for many, the ideal and real practice seem to differ. Lending at interest goes on all the time.

The Time Element in Interest and Usury

What interest charges, then, are accepted? A crucial point is that the Qur'an discusses usury in terms of the relation between the amount lent and the amount repaid, but not in terms of the amount of time elapsing between the loan and repayment.[42] This means that even if a low rate of interest is charged per month or year, it can eventually add up to an absolute amount that is considered usurious. What matters to rural Gambians is not so much the rate of interest per unit of time, as the ratio of interest to principal. As a district chief explained it, his court might find a loan at 10% interest over a year acceptable, but it would never consider a loan at 10% annual interest over ten years acceptable, because that would be "doubling". Moreover, he said, even a loan at 2% annual interest over 50 years would be unacceptable, for this too would be doubling.[43]

From this principle follow several others fundamental to Gambian financial custom. One is that the duration of loans is usually kept as short as possible, for the lender's sake if not also for the borrower's.[44] Local-level loans of cash, seeds, food, or other consumer goods are rarely if ever issued for periods exceeding one year, and most are lent for not longer

than seven months. For small household goods, as noted above, loans of only a few days are common.

Preferences for short-term lending seem to have militated against local-level credit sales of large, non-divisible goods, including animal-drawn and engine-driven farm machinery. These things simply are not available to farmers to purchase by instalment or other credit arrangements, except from the co-operatives. Farmers certainly perceive this as a gap to be filled. Development planners may see it this way too, but they should also realize that "medium-term" or "long-term" loans accruing high absolute interest will cause resentments which might lead to deliberate non-repayment.

In informal rural Gambian lending, interest is not necessarily assumed to accrue at a constant rate, month by month, as it does in a European bank account. Instead, charges are geared to the agricultural cycle. A lender who lends one sack of rice to an impoverished farmer early in the hungry season, demanding two in return at harvest time (in defiance of Qur'anic law), will also lend one sack for two to another borrower who needs a sack later in the hungry season, even though the two borrowers are expected to repay at the same time. Farmers asked about such cases insist that the lender is following the same policy for both. So a three-month loan often carries the same actual interest charge as the six-month loan (one sack, or 100% interest). If time is money, it sometimes comes only in large denominations.

Gambian farmers, then, do not always think of interest in terms of annualized rates. They repay seasonal loans at harvest time if they are willing and able to do so; otherwise they wait until the subsequent harvest. So they are more accustomed to thinking of loan durations in terms of 6 or 18 month periods than in terms of 12 month periods. After the end of a harvest season, interest on an unrepaid loan may be expected to jump to its double on the expectation that it will not be repaid until the following year's harvest. It accrues stepwise, jumping year by year.

But at least as often, no further interest will be charged after the first year. The lender simply agrees to defer collecting the principal and the initial interest until the following harvest, then collects the same sum. The interest-time function turns flatly horizontal. Rural groundnut seed lenders charging 100% on six-month loans sometimes demand further accrued interest after the harvest season; others do not. Shopkeepers sometimes sell items like cigarettes on credit for 100% interest within the month (as for buyers who may have monthly salaries or remittances). But these loans do not simply keep piling up interest if unpaid. It makes little sense to think of them in terms of a 1,200% annual rate, and no one does.

As these various patterns suggest, linear time is not taken for granted in loan arrangements. Rather, there are at least several modes or idioms, temporal or atemporal, linear or non-linear, for constructing agreements. Which will be chosen is negotiable at the time of the deal, if not also re-negotiable later. Time is an optative element.

This variable conception makes sense in communities where many have no major sources of cash beside annual rainfed agriculture, but where some

farmers or families do have remittances, salaries, and trading incomes throughout the year. Time seems in some way to be a "bracketable" or detachable part of rural Gambian interest calculations, included for "rates" or excluded for "ratios", and negotiated into or out of contracts. Flexibility is the essence of the system. Interest and usury are context-specific.

Is the time dimension becoming more deeply entrenched or more prominent in local thought about usury? This is hard to determine. Statutory law and co-operative society practice have been based heavily on the linear-time principle, and in the past two decades farmers in about every Gambian village have dealt with the co-operatives. Evidence from other parts of West and East Africa suggests that "informal" land pledging agreements have newly begun to incorporate time deadlines, becoming foreclosable mortgages, in crowded rural areas where competition for land has grow severe. In The Gambia, too, secular changes may be occurring in financial thinking, such that deals are being more closely linked to linear notions of time. Snapshot-like field investigation cannot track such changes well, and more longitudinal study is needed.[45]

How Lenders Conceal Interest Charges: The Commodity Switch and Other Strategies

Another principle following from the Qur'anic prohibitions is that in lending for any but the shortest periods, lenders seek ways of making profits from lending without appearing to charge interest. To their borrowers and to outsiders, they may seem to be concealing or disguising interest charges. Several conventionalized dodges are found in The Gambia. These are known by the Arabic term hīla (pl. ḥiyal), meaning legal devices or evasions.[46] One way, where written records of loans are kept, is to record loan agreements that noting only the amounts to be repaid, but not the smaller amounts actually lent. (Local court records examined on debt cases do not mention interest charges, though of course these are standard practice in reality.) Other strategies involve semantics: a fee for a loan becomes more acceptable when it is considered a gift or a service charge.

Other elaborations involve reclassifying loans as sales and resales. A wishes to lend B money and B wishes to borrow it. A "sells" B a sack of sugar with delayed payment, and re-purchases the sack of sugar immediately, for cash, at half price. Thus B receives cash immediately, and returns its double later. The loan is disguised as two sales, and the sack of sugar need never move from the lender's shelf.

A common way of concealing loan profits is by insisting that a loan in one form be repaid in another. Thus, loans issued in cash in June are frequently collected in groundnuts upon the December harvest, even if the borrower could easily have sold the groundnuts elsewhere for cash first to repay in cash, and even if the lender will only then sell the groundnuts to a third party for cash.[47] Even though both borrower and lender usually know well the cash values of the things borrowed and lent, the switch in forms of payments makes accusations of usury less likely. The changes in values of the two items over the course of the loan, and the fact that these

changes are not fully predictable at the time the agreement is made, further obfuscate the lender's profit. All are aware that the lender is making a profit, but no one may be sure how much.

The switching practice in turn leads to interesting patterns of interest charging or profit-taking in credit. In loans where the forms of payment are switched, interest rates are usually much higher than in loans where they are not. Thus, while a 300% interest charge in a seasonal cash loan repaid in cash is virtually unheard of, it is common practice for shopkeepers to lend in cash 25% of the expected value of a bag of groundnuts, demanding the payment of a full bag upon harvest. In monetary terms, this would of course be calculated as a charge of principal plus 300% interest. Interest rates in cash-for-cash loans or groundnut-for-groundnut loans seldom rise above 100%, and in many cases are much lower.

Borrowers generally know all this, of course, and they perceive that it is in their interest to make agreements to repay in the same form as they borrow. But since most credit is demand-led, lenders have the upper hand in dictating the terms and will usually succeed in effecting a switch.

Two general conclusions follow from the foregoing observations. One is that credit analysts working in The Gambia should not assume that the same interest rates acceptable in short-term loans will also be acceptable in longer-term loans. The second is that they should not simply record, generalize about, or set interest rates without considering BOTH the forms in which loans are issued and the forms in which they are collected. This is an area where conventional European or American modes of economic analysis may simply be inapplicable.

Loan Forgiveness Custom: A Safety Net for Borrowers

While rural Gambians do not always calculate interest as though time were linear and inexorable, rules and conventions about loan forgiveness in fact prevent interest from accumulating ad infinitum as time passes. On seasonal loans, if two or three years elapse without a repayment, the lender is usually expected to forgive the loan. (He or she will of course be wary of lending to the same borrower again.) As Gambians know, The Qur'an counsels lenders to give needy debters extra time, or better, to forgive their debts.[48] Villagers expect the same of public governmental and other institutional lenders.[49]

Further Differentials

Some rural Gambians state that loans issued in cash should carry higher interest than loans issued in kind, other things being equal.[50] Why cash loans should be more expensive is not clear. One reason might be the opportunity cost of capital for lenders: they can use money in more ways than seednuts, for instance, and seednuts take time to sell for cash. Another reason might be that the value of cash is easier to assess than the value of groundnuts, which can vary in size or quality; and therefore a cash loan is more likely to be

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judged usurious. Might it be that a kind of "spiritual risk premium" is being added into the interest charge in cash loans?

The size of loan may make a difference too. Whether coming from kin or neighbors, relatives, or merchants, the smallest loans are often expected to be given free of interest or profit. As the quantities or values of loans rise, so might the rates of interest charged. One group of farmers indicated hypothetically that while they might expect a seasonal loan of D. 10 to be issued interest free, they would expect D. 100 to be issued at 5% interest, D. 1,000 (a rare loan) at 10% and D. 10,000 (rarer still) at 20% -- between the same borrower and lender, over the same period. But since the persons engaging in small and large transactions are likely to be different, this may not be the case in the aggregate, and there are signs that the reverse may be the case when different lenders' and borrowers' transactions are compared.[51]

The differences between the lending and borrowing habits of indigenous Gambian ethnic groups have not been thoroughly studied -- this is a field ripe for further research -- but there is evidence of substantial variation. Puetz and von Braun (1988: 18) have found that Wollofs charged an average of 58 percent higher interest on loans than other Gambian ethnic groups.

Village or town lenders appear to give more generous terms to wealthier borrowers and those who have saleable property (livestock, machinery) than to poorer borrowers or those who do not.[52]

In Sum

Informal interest charges in The Gambia depend on many things, in addition to strictly economic considerations of lending risks, opportunity costs, etc. These include the presence and closeness of kinship and friendship ties, and the ethnic identities of the borrower and lender. They also include the duration, amount, and time of year of the loan, the solvency of the borrower, the nature of the commodity borrowed, and its relation to the one returned. Time and money are not necessarily understood as linked in linear function, and the notion of "rates" per unit of time appears artificial and alien to Gambians in many contexts. The complex calculations and negotiations involved in Gambian interest charges are not all easily amenable to conventional western economic analysis, and they may not conveniently fit ordinary definitions of "markets".

Some Implications for Financial Institutions

Gambian farmers have seen everything, from free hand-outs to interest charges of several hundred percent; and in this sense at least, there is some latitude for policy experimentation. But these farmers' understandings of interest charges are so complex, and so deeply embedded in religion and culture, that institutional lenders are advised to design and redesign their

policies sensitively, with carefully watched pilot projects and open-minded listening.

Does institutional finance need to conform to all Islamic proscriptions about usury? Some say not if the institutions are public, as in a co-operative, since the public supposedly benefits from interest charged of its members. Some reason, too, that the law of the land governs banking and financial institutions, that the public has a sacred duty to abide by the law of the land, and that this duty can be just as important as other sacred duties. But a privately held enterprise is thought guilty of ribā in charging interest for someone's personal profit where this is not destined to be shared with family or community. Some Gambian rural traders claim they do not save in banks because doing so would be charging interest. This claim should not always be taken at face value -- they often have other reasons too -- but the idea is always present in decisions and debate.

Although the Qur'an explicitly forbids charging high interest, it does not explicitly forbid paying it. Rural Gambians debate whether such borrowers are sinners too. A Mandinko marabout in Lower River Division explained that borrowing at interest to feed one's family is not sinful, but borrowing for strictly personal or unnecessary purposes is. While an institution charging high interest may be resented and perhaps thought sinful, the religious beliefs may not necessarily diminish the demand for its credit. No evidence is available on this point.

Of course, Islamic banks in other parts of the Muslim world have their own hiyal or legal devices for evading Qur'anic prohibitions on interest. These cannot be examined in detail here, but they usually label such payments "profit" or "profit-sharing" instead of interest; this is more convincing if they declare them at the end of a year or a lending term rather than the beginning. Provisions for risk-sharing between borrowers and lenders may be incorporated to avoid Qur'anic prohibitions on unilateral risk.

It was noted above that Gambians expect loan forgiveness, from institutional as from informal lenders, in cases of need and delayed repayment. Here the issues are not just religious or economic. Institutional credit is political. Just as dispensing loans can win voters or supporters, forgiving loans maintains loyalties. It is to the advantage of politicians that loan forgiveness by institutions not be too routinized: that there be leeway for discretion about clemencies due to droughts, or amounts of time elapsed and interest accrued. Politicians try to arrange that announcements of new loan programs or forgivenesses be associated with their own names (and that they occur in election years). Patronage systems reinforce the Islamic-inspired safety net of forgiveness for borrowers, but they may de-synchronize the timing from periods of peak need.

We turn now away from the subject of Islamic law to the other major international legal influence on Gambian financial custom: the legacy of the British Empire.

V. National Moneylending Law: The Imperial Legacy and the "Per Annum" Rule

Gambian national statutory law, copied with little modification from British law, prohibits usury under specific terms. To start with, the relevant law is written only with reference to money: it is the Moneylenders Act. The wording of the the Act refers to money loans but nowhere specifies whether the Act applies to cash loans collected in other commodities.[53] The law is thus technically irrelevant, or only ambiguously relevant, to much of the rural lending in The Gambia.

The Moneylenders Act, with its deeply embedded assumptions about what constitutes interest and usury, has a centuries-long pedigree exotic to Africa.[54] Its immediate basis was the Money-Lenders Act of 1900 in the United Kingdom, redrafted and amended in 1927 to the effect that transactions would normally be considered unfairly harsh at interest rates above 48% per year. This figure was copied straight out. The Gambian law developed in the form of the Moneylenders Ordinance of 1934, which required the registration of moneylenders, and the Moneylenders Act of 1955 (Cap. 126), revised under the Revised Edition of the Laws Act of 1965. This was the law still in force and being distributed in pamphlet form by the Government Printer in Banjul in 1988.[55]

The law defines moneylenders as "any person who lends money at interest or who lends a sum of money in consideration of a larger sum being repaid" (Cap. 126, sec. 4), and it requires them to be licensed. It shows no acknowledgement that most of the moneylending in The Gambia is done by non-specialist moneylenders.

The law refers to "interest" as permissible under certain circumstances. In this respect it differs sharply from Qur'anic teaching, which never explicitly condones interest but instead states prohibitions on "usury" (riba) variously interpretable by some to allow some charges resembling interest. The law makes it clear that interest is to be calculated as an annual <u>rate</u> per unit of time, rather than simply as a ratio of principal to interest. Implicit is the assumption of linearity in the relation of time to money.

> The Moneylenders Act of The Gambia states (Cap. 126, sec. 13, para. 1):
>
> The interest which may be charged on loans, whether by a moneylender or by any person other than a moneylender shall not exceed the respective rates specified hereunder --
>
> (a) On loans secured by a charge on any freehold property [or government bonds or other specified forms of collateral] simple interest not exceeding the rate of fifteen per centum per annum for the first five hundred pounds or part thereof and not exceeding the rate of twelve-and-a-half per centum per annum on any amount in excess of five hundred

pounds;

(b) on loans secured by a second charge... [2.5 percent higher than in (a)];

(c) on unsecured loans simple interest not exceeding the rate of forty-eight per centum per annum.

The "per centum per annum" clauses force lenders to record interest, and courts to assess fairness, in terms of time elapsed. Later sections makes doubly sure (Cap. 126, sec. 16, para. 2, as follows; see also sect. 21):

> Where the interest charged on a loan of money is not expressed in terms of a rate per centum per annum the rate of interest per centum per annum charged on the loan shall be calculated according to schedule A [which shows how to divide years into weeks, months, weeks, and days]... or schedule B to this Act [which gives the algebraic formula for calculating interest, by months elapsed].[56]

Significantly, the British-based laws still in force in The Gambia include nothing like a statute of limitations: they mention no period of time after which the interest build-up becomes unfair, and no period after which a loan or any of its interest must be forgiven.[57] Nothing in the law limits the ratio of interest to principal. According to the letter of the law, then, an unrepaid loan may legally continue accruing interest indefinitely. What the Qur'an condemns as "doubling and quadrupling" is quite legal under the British-based system, provided the rate is gradual enough and enough time elapses. This is a key difference between the British law and the local conventions based on Islamic and indigenous law and custom.

By the 48% per annum rule, many of the seasonal loans that Gambian farmers contract with each other and with shopkeepers are illegal. A six-month loan at 100 percent interest -- about the most common arrangement -- carries more than four times the allowable interest if calculated on an annualized basis.[58] Interest charges on many of the shorter-term loans, for instance larger traders' loans to smaller traders for stocking up, appear rather ridiculously high when annualized: they may come to well over 1,000 percent. Annualization, and laws based upon this kind of calculation, become meaningless. Of course, since loans not issued in cash may not be deemed subject to the Moneylenders Act, the law is only of limited relevance anyway.

Other Areas of Fit and Misfit in the Moneylenders Act

The Moneylenders Act's breakdown of interest rates above, in terms of security offered, tacitly takes into account lenders' needs to pass on the risks of unsecured lending to borrowers as an interest premium. Seen in a more critical way, it allows them to extract higher rates of profit from poorer borrowers, who are unlikely to have collateral to offer. Fair or unfair, the direction of the difference fits Gambian local practice.

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There are, however, significant areas of misfit. Allowable formats for repayment schedules are also set out in English, but not in the Arabic tongue that many Gambians learn to write in Qur'an school or any other language.

Strangely, while the Moneylenders Act specifies allowable interest rates in terms of rates, thus accommodating loans of any amount (with only one minor differential for amounts above or below 500 pounds), it specifies the fines in terms of a fixed (or presumably a maximum) amount:

> Any person who loans money at a rate of interest higher than that authorized by this Act shall be guilty of an offence and shall be liable, on summary conviction, to a fine of fifty pounds in respect of each such loan. (Cap. 126, sec. 14, para. 1, emphasis added)

The law discriminates against smaller lenders. A loan of ten pounds or a thousand pounds would incur the same fifty-pound fine. The lender who lent 1,000-pounds in ten-pound amounts would risk 100 times the fines of the lender who lends a single thousand-pound loan. Of course, lenders are likely to try to pass such risks or costs onto the lenders as premiums on interest. So this part of the law disfavors not just small lenders, but also small borrowers.

The Gambian laws include provisions whose enforcement would block some hiyal (legal evasions), but not others. They prohibit direct or indirect payment of interest in advance by deduction from principal sum borrowed or otherwise (Cap. 126, sec. 15, para. 1). They prohibit "negotiation fees" (sec. 17) and bonuses, fines, expenses, etc. that might be levied as surrogate interest charges (sec. 13, para. 3). But as noted above, the laws do not address the commodity-switch device, for instance cash loans repaid in groundnuts -- one of the most important devices in local practice.

Loans with pledged property subject to the Pawnbrokers Act of 1905, revised 1965 (Cap. 136) and still being issued from Banjul in 1988.[59] This law too lists maximum profits on loans or debts allowable, in terms of rates, calculated by monthly and fortnightly intervals. For instance:

> On a loan of above forty shillings --
> For every month or part of a month for every sum of two shillings and sixpence or fraction of a sum of two shillings and sixpence... one halfpenny (Cap. 136, sec. 12, item B.)

Here again, then, the profits may legally continue to rise indefinitely, as long as they rise slowly enough. What matters by this law too is not the amount of interest finally paid, or its ratio to the principle, but only the relation between the time and the money.

VI. Conclusion: Financial Customs Across Cultures

In practice, the national moneylending laws are not widely heeded in the

countryside. There is no reason why they should be: their stipulations appear tailored to a different culture entirely, and only arbitrarily applied to this West African setting. More powerful by far is the Qur'anic law that is universally known, if debated in meaning. That local court records do not show interest payments that are obviously there in reality shows how little attention is paid to the British-based statutes: not just high interest but all interest is kept secret from the government in informal lending. But Gambian financial custom is equally remote from the letter of Qur'anic law in that, as elsewhere in the Muslim world, interest is being charged and only thinly veiled between borrowers and lenders. The Gambia has two legal codes, then, based more on exogenous ideals than on actual practice. Hence the wide latitude for borrowers and lenders to arrange their own deals on their own terms. This rural and peripheral area of West Africa, accustomed to centuries of competing alien powers and philosophies, is in a sense ironically metropolitan in its outlook and its tolerance.

Probably similar cultural clashes and overlays concerning time and money, and focussing on interest and usury, are widespread in Africa: as widespread as the Qur'an in the northern half of the continent, and the Bible in the southern half; as widespread as the legacy of colonial rule and the widening reach of international institutional finance. Would an African sage advise a young tradesman not to forget that time is money? Probably not without knowing whom that novice will be dealing with. That is the difference.

Appendix: Implications for Policies and Projects

Possibilities

There is much latitude for experimentation in project design. Rural Gambians have seen most everything. They have also seen other Gambians devise complex ways of dodging rules and laws, including sacred laws.

Official attempts to regulate the amounts of interest charged are likely to fail.

Government policy can, however, influence the kinds and numbers of urban-based merchants who trade in particular commodities in the countryside, and who lend in connection with them.

Savings and Credit

More emphasis should be placed on savings, to balance the heavy emphasis on credit, in policies and projects. Although they save mainly in non-monetary forms, rural Gambians would like more, and more convenient, ways of saving cash. The kondem boxes, the money-keepers, the requests for delayed wage payments, and the rotating savings and credit associations all suggest an illiquidity preference and a possible demand for easier saving deposit channels.

The existing institutions in The Gambia leave gaps for linkages yet untried, for instance between private voluntary organizations and commercial banks.

Organizations that can link savings and credit are more likely to succeed, and to be of service, than those that do not. Rotating savings and credit associations are a model for emulation in several respects, including their absence of paperwork, their simplicity and ease of operation, their use of peer group pressure for repayments, and their constant re-circulation of cash in a rural community.

Interest

Institutions are subject to Islamic ideology concerning interest, but the ideology is more tolerant of some kinds of financial institutions than others, and the public has ways of rationalizing counterventions.

"Market interest rates" is a concept that can mislead in several ways. Interest rates are not a "perfect market": they depend on borrowers' and lenders identities, relationships, and contextual factors. They not only fluctuate but also vary simultaneously. Informal interest rates vary from 0 to several thousand percent annualized. Information about interest, moreover, is usually secret -- far from "perfect information".

Rural Gambians understand interest not always as "rates", but often more as

"ratios". The idiom of annualized rates, so familiar in the West as to be taken for granted in financial dealings, is not similarly second-nature to Gambians. Time is not necessarily conceived of as linear. It is detachable, optative, and not taken for granted in interest calculations. It is taken into account, however, in debt forgiveness.

One should not assume that the same interest rates acceptable in short-term loans will also be acceptable in longer-term loans. It is easier to collect shorter-term than longer-term credit. This is probably even more true in Islamic societies like The Gambia than in other relatively poor parts of the world. Institutional lenders may be able to charge higher interest than they are accustomed to charging if they keep their loans short enough.

There are cultural pressures in favor of smaller loans. Gaps are left in large-scale, long-term lending. Large-scale investments like milling or threshing machines, then, are likely to be impracticable to finance with credit, and unlikely to be replaced by local initiative except by unusually solvent traders or businesspeople. Such gaps may be too hard to fill with institutional credit at anything like "market rates" and require hire-purchase, grants, subsidies, or other arrangements instead.

One should not simply record, generalize about, or set interest rates without considering BOTH the forms in which loans are issued and the forms in which they are collected. This is an area where conventional European or American modes of economic analysis may simply be inapplicable.

Some institutional lenders to farmers might experiment with options of interest scheduling other than linear rates. Interest charges that accrue stepwise each year, in the trade season, might more closely reflect the realities of rainfed farming cash-flows for some purposes.

Lenders should be prepared to forgive loans that go more than two or three years without repayment. Letting interest accrue ad infinitum is not locally considered fair. This is a further reason for caution with large-scale loans, for instance for heavy machinery.

"Depreciation" funds for replacing goods like heavy machinery by regular deposits are likely to be conceived of as unnatural. They are based on a conception of a linear time-money relationship that is not second-nature to rural Gambians. Moreover, they conflict with local assumptions about the transferability of profits from one "sector" of economic activity into others.

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Notes

1. This study is based on field research conducted in April and May, 1987 and from July to October, 1988, under the Economic and Financial Policy Analyses Project of the Harvard Institute for International Development with the Ministry of Finance and Trade, funded by the U.S. Agency for International Development. All opinions expressed, however, are my own. In addition to open-ended interviews, a structured survey, whose results are still being processed, was conducted with equal numbers of men and women informants, totalling about 138 in the first visit and 186 in the second, each visited repeatedly in five randomly chosen villages in Foni Berefet District (Western Division) Niani District (MacCarthy Island Division), and Wuli District (Upper River Division). Working with experienced local enumerators and interpreters chosen for their previous ties and rapport in the particular villages, I stayed mainly in two of the villages and benefited from several key informants. For more on the research methods see Shipton 1987, Appendix.

2. "We reckon hours and minutes to be dollars and cents", wrote T.C. Haliburton (1796-1865) in The Clockmaker. "Take away time is money, and what is left of England?" wrote Victor Hugo in 1862 in Les Miserables. Weber's 1904 classic, The Protestant Ethic and the Spirit of Individualism, was far from the first study to trace links between religious and economic ethics, but fused them most compellingly. Marx's Capital criticized as "commodity fetishism" the assumption that "money begets money".

3. Formal and informal schooling, however, have prepared few rural Gambians for the arithmetic involved in calculating interest as rates. Those who can manage the math may be able to take advantage of neighbors who cannot, in dealings among themselves or with financial institutions.

4. The formal-informal dichotomy is of course artificial, and used here only for its heuristic value. In some respects "local customs" of ordinary people can be as formal as, or more than, economic behavior in and around official bureaux, where it can sometimes be very informal indeed.

5. A useful body of recent economic surveys variously comparing the roles of formal and informal financial systems in particular West African countries includes Christensen 1988, Cuevas 1989, Graham et al. n.d., Hammsa 1984, Puetz and von Braun 1987, Tapsoba 1982, Tuck 1983, and Walker 1987. Most emphasize quantitative dimensions. Comparing the findings from the different countries is a task ahead.

6. See Haswell 1975 for detailed descriptions of the trading firms' and their agents' rural workings.

7. For a fuller discussion of rural Gambian savings strategies, see Shipton 1987: 10-16.

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8. Farmers give several reasons for preferring to save their wealth in stock, in addition to the subtler considerations of gender noted above. These include the fact that animals breed, the advantages of milk and manure production, the usefulness of animal traction, the ceremonial values of animals, and simple satisfaction in having herds to watch.

9. For comparisons see Tuck 1983: 66, on Senegal; Graham et al. 1987: Ch. IV, 18-21, on Niger; and Cuevas 1989:9, on the Kindia and Nzerekore regions of Guinea.

10. A Basse court record describes a civil case in which a shepherd entrusted 80 dalasis to a shopkeeper for safe keeping, and the shop's cash was later stolen by thieves. The shepherd sought the full 80 dalasis. The court ruled that the shopkeeper owed the shepherd 40 dalasis, half the amount deposited. Villagers interviewed disagreed on the correctness of the decision.

11. Men sometimes also belong to rotating savings and credit associations, and some salaried men, for instance in the Gambian army, are known to form them.

12. See Shipton 1987: 29-32 for other pros and cons of rotating savings and credit associations.

13. The exception is ROSCA participation for one whose turn falls early in the cycle. Since she or he repays later small amounts totalling the amount borrowed, this one benefits from inflation.

14. In 1986, 48% of the money supply of The Gambia was reported to be outside of the banking system (Ramamurthy 1986: 25).

15. In May 1987 the Basse branch of the GCDB (one of only two branches of the bank outside the greater Banjul area) reported that 49% of its 858 savings depositors had less than 250 dalasis in their accounts (i.e., less than the value of one sheep). Interviews with bank staff suggested that most of the roughly 100 farmers (people whose primary source of income is farming) saving at the bank were among those with less than 250 dalasis. Only an estimated 10-15% of the 858 depositors were women. Only about five farmers were currently borrowing from the branch.

16. Von Pischke 1983 concisely summarizes poor rural peoples' incentives and disincentives to save in financial institutions; a forthcoming book of his expands on some of the ideas and suggests a balance between savings and credit.

17. The Agricultural Development Bank had tried these in the early 1980s, but it was unable to sustain them before it failed.

18. Tuck (1983) suggests that in rural Senegal, loans between relatives tend to carry higher interest than loans between non-relatives. This is a most unusual finding deserving further attention, but it must be taken cautiously since it was based on a short-term quantitative survey and apparently not on intensive interviews.

19. Patrilineal kinship refers to the practice of reckoning descent and forming social groups on the basis of ties through males. Virilocality is the practice whereby a married couple lives in the original home of the husband.

20. Currently Mandinka, Jola and Manjago bridewealth appear often to amount to less than D. 500, but among the Wolof bridewealths appear to fall around D. 1,000, and Fula bridewealths frequently exceed D. 2,000. Families of particularly well-educated or well-connected women may demand much higher bridewealth. In addition to these transfers, grooms and their families are usually expected to provide cattle or other livestock for slaughter, and other food, in the weddings, and grooms to give their new wives goods like beds, boxes of clothing, pots and pans, radios and tape recorders, watches, and sometimes animals and jewelry as they set up house.

21. Cuevas found, in two regions of Guinea, that about 90% of a sample of 250 arranged their main informal financial loans in their own villages (1989: 8).

22. See Robertson 1987 and sources cited therein for a study of African share contracting, including a chapter on The Gambia and Senegal.

23. Christensen 1988: 68 similarly comments on the absence of professional moneylenders in Burkina Faso.

24. Lebanese and Ako merchants have until now more or less confined their direct operations to the Banjul area, though some may have agents in the smaller towns.

25. Most of the larger-scale traders in The Gambia are men. Among Mauritanians a particularly high proportion are male: in The Gambia, Mauritanian men outnumber Mauritanian women by over three to one (Population and Housing Census, 1983, Provisional Report, p.30).

26.Sura II, Part III of the Koran reads, "And if the debtor is in straightened circumstances, then (let there be) postponement to (the time of) ease; and that ye remit the debt as almsgiving would be better for you if ye did but know" (verse 280).

27. Why no merchant loans to kin on a concessionary basis appeared to be re-lent at higher interest is unclear, but this may have been a result of reporting inaccuracies.

28. See Jones 1986: 15; Clark 1987: Table 1 for yearly figures from 1974/5 to 1985/6. Haswell 1975 describes some changes in groundnut marketing and credit patterns up to the mid-1970s.

29. These advantages are discussed, and modifications recommended, in Jones 1986, a study of the efficiency of The Gambia's groundnut marketing system. See also Clark 1987.

30. Urban merchants are said to charge substantially higher interest for foreign merchants borrowing for cross-border trade, perhaps because the risks of lending are high.

31. See Shipton 1987. The main government organ assisting small businesses is the Indigenous Business Advisory Service (IBAS), of the Ministry of Economic Planning and Development. IBAS which has issued credit (and training) to Gambian small entrepreneurs who pass a screening based on character assessment and aprofitability assessment of the proposed businesses. Borrowers must have savings accounts, provide guarantees and collateral, and contribute 20% of the total amount of credit. Loan sizes may exceed 10,000 dalasis. 11% interest is charged, an amount below bank rates. By February 1987, IBAS reported a repayment rate of about 90%. IBAS has tried to emphasize productive activities such as poultry, fishing, and agricultural tool manufacturing, but also lends to retailers. IBAS has project officers only in Banjul, Barra, Bansang, Farafeni, and Basse, and most of its clients are based in and around these cities and towns.

32. Dunsmore et al. noted moneylending rates varying between 50% and 150% (1976: 310). Haswell noted that a wealthy compound head who lent money in Genieri village charged rates between 49% and 157% over eight months in 1973-4 (1976: 186). Reports collected for the present study in 1987 suggest that these figures do still represent the most common range for seasonal loans -- the figure of 100% being the most commonly heard -- but that the rates may vary between 0 and over 1,000%, if calculated in monetary values and on an annual basis. As one might expect, it is shorter-term loans that reach the highest rates when calculated on an annual basis.

33. While "western" church-based aid organizations like Catholic Relief Services are active in the countryside, Christian religious influence is small.

34. Some of the indigenous aspects of religious include ancestral spirits, local celebration scheduling, and some forms of witchcraft and sorcery, house magic, worn amulets, etc.

35. In Mandinka, imam is <u>alimaamo</u>, and the French term <u>marabout</u> is translated <u>mooroo</u>.

36. The first relevant passages occur in Part III, Sura II, "The Cow". Verse 275: "Those who swallow [charge] usury cannot rise up save as he ariseth whom the devil has prostrated by (his) touch. That is because they say: Trade is just like usury: whereas Allah permitteth trade and for biddeth usury...As for him who [refraineth and] returneth [to usury] -- Such are rightful owners of the Fire. They will abideth therein." Verse 276: "Allah hath blighted usury..." Verse 282: "O Ye who believe! When ye contract a debt for a fixed term, record it in writing. Let a scribe record it in writing between you in (terms of) equity." [Pickthall translation]. See also the note that follows. In another translation of the Sura of "The Cow": "It shall be no offence for you to seek the bounty of your Lord by trading"... "Those that live on usury shall rise up before Allah like men whom Satan has demented by his touch; for

they claim that usury is like trading. But Allah has permitted trading and forbidden usury" [Dawood Penguin translation, pp. 344, 354.]

37. See Schacht 1964: 12, 145-8 for a general treatment of ribā in Islamic law.

38. Some consider it ironically to be a kind of debt that the lender acquires to the borrower, for which the borrower may or may not forgive him or her on the judgment day.

39. The sura of "The Cow" states, "Believers, give in alms of the wealth you have lawfully earned" (The Koran, Dawood trans., p. 354). "Lawfully" is taken to exclude wealth earned as ribā.

40. "Eating" or consuming the rewards of usury will give the lender a swollen belly, some Gambians say; and vultures will pull out his intestines. For parallels in other African traditions (Christian and local), in which specific prohibitions on earning are linked with specific prohibitions on spending, see Shipton 1988. For a detailed historical treatment of concepts of usury in Judeo-Christian traditions, see Nelson 1949.

41. They say trade profits become sinful, however, when a seller raises them expressly to take advantage of a particular buyer known to be in difficulty.

42. Part IV, Sura III, "The family of 'Imran'", Verse 130: "O Ye who Believe! Devour not usury, doubling and quadrupling (the sum lent)... and ward off from (yourself) the Fire prepared for disbelievers." See also Part VI, Surah IV, "Women", Verses 160, 161 (Pickthall trans.). Though there is no explicit mention of how long it should or should not take for interest to accrue to the double, the Qur'an does tell believers, "So do not fail to put your debts in writing, be they small or big, together with the date of payment" ("The Cow", Dawood trans., Penguin, p. 355). The emphasis on the date here suggests recognition that interest may accrue, in one way or another, as time progresses.

43. Any loan arrangement involving "double profit" is likely to meet with disapproval in The Gambia. In the case of crop loans, the idea of "doubling" itself has a double meaning. As a district chief explained it, Allah gives humans profit from seeds sown, by multiplying them for harvest. If humans then lend these at interest to obtain further profits from each other, they are seeking double profit, and thus committing a sin (in Mandinka, junubo). Muslims are taught that only divinity should be able to make rewards multiply. The Qur'an repeatedly states that the charitable will collect back on the day of judgment. "He that gives his wealth for the cause of Allah is like a grain of corn which brings forth seven ears, each bearing a hundred grains" (Sura of "The Cow", Dawood trans., p. 353). "That which you seek to increase by usury will not be blessed by Allah, but the alms you give for His sake shall be repaid to you many times over" (Sura of "The Greeks", verse 39, Dawood trans., p. 191).

44. There are, of course, other reasons for lenders to keep loans short, such as the opportunity cost of capital and the possibility of borrowers' moving away.

45. Haswell's research on Genieri Village in The Gambia, conducted over 25 years, is one of Africa's best examples of longitudinal research. She does not deal conclusively, however, with the questions raised here about time perceptions in interest and usury.

46. For surveys of hiyal, legal devices, in other Islamic countries -- a subject to which books have been devoted -- see Khan 1929; Schacht 1964: ch. 11 and pp. 208-11, and the bibliography on p. 242; and Rodinson 1974: 36ff. In The Gambia, borrowers and lenders may not believe that divinity will be fooled; buy many say they are more comfortable following the hiyal strategies regardless. Schacht's classic work discusses sympathetically the relation between theory and practice in Islamic contract law.

47. The hiyal principle helps explain, I think, why Haswell observed in Genieri village that "Loans were not always made in cash but frequently in food grains payable in cash or groundnuts" (1975: 188).

48. Gambians likewise speak of Allah as merciful and forgiving, and they supplicate this quality. Muslims use many of the same contexts to discuss forgiveness between humans as they use to discuss divine forgiveness of humans, just as Christians supplicate their divinity to "forgive us our debts as we forgive those who debt against us" in the "Lord's Prayer".

49. Compare this finding on courts among the Chagga of Tanzania in the 1940s and 1950s: "it seems that where the claim was promptly brought to the court, before a large debt piled up, the court was more likely to allow a high rate [of interest]" (Moore 1986: 188).

50. Findings of Puetz and Von Braun (1988: 18) agree with my own on this point: "food loans are lower [in interest] than other loans, all other factors held constant".

51. Puetz and von Braun found in central Gambia that "the higher the loan amount the lower the interest" (1988: 18). Hill notes too, in her study of Hausaland in Nigeria and Karnataka in India, that "as a general rule, bigger creditors charge lower interest rates" (1982: 215).

52. Haswell (1976: 186) and Dunsmore et al. (1976:310) found the same differential in their Gambian studies, but Puetz and von Braun report no such difference discernable in theirs (1988: 18). Hill (1982: 215) found the differential in Hausaland, Nigeria, as have others elsewhere in West Africa.

53. The nearest other law that might apply is the Pawnbrokers Act.

54. For a thorough treatment of medieval European Moneylending laws have appeared and disappeared in England since at least the sixteenth century. Henry VIII's statute of 1541 forbade interest over 10 percent per year. In subsequent reigns over 170 years, usury law was scrapped and re-instated at

rates that varied from eight percent to five percent. By 1867 it had been re-abandoned.

55. Though issued two years after internal self-government and on the year of Independence, it is unabashedly British, printed in London, and listing amounts in "pounds", not dalasis, which became the national currency in 1971. It still lists the capital city as Bathhurst, not Banjul as renamed in 1973.

56. The formula given in Schedule B of the Moneylenders Act for calculating an interest rate, per cent per annum, is

$$\frac{100 \times I \times 24}{(N + I) \times P \times L}$$

where I = Total interest payable.
N = Number of instalments.
P = Principal.
L = Number of calendar months in the intervals between instalments.

57. The law stipulates, however, that moneylenders may not wait more than a year after (unspecified) "cause of action" to start legal proceedings to recover money or security (Cap. 126, sect. 30).

58. 48% annual interest after two calendar years remains just short of the "doubling" that the Qur'an expressly forbids. But since most rural loans are contracted during the hungry season and repaid during the harvest and trade season anyway, the difference between 48% and 50% is not of great importance.

59. Tellingly, the Pawnbrokers Act still in force requires the pawnbroker to exhibit, in large letters over his outer door, "his Christian name" and other names (Cap. 136, sec. 10, item 1b)... even though the person is 20 times more likely to be a Muslim than a Christian.

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THE IMPACT OF ADJUSTMENT POLICIES ON AFRICAN INFORMAL FINANCIAL NETWORKS

by

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Introduction

In the vast majority of African countries, one may observe the inadequacy of financial systems when these are confronted with the demands of development. The major portion of the rural and urban populations have no access to institutional credit. The non-institutional, or informal, financial networks play, therefore, a crucial role. Now, the financial crisis and the intensification of financial imbalances appears to have strengthened the informal character which the financial networks have taken on. The question arises of knowing what short-, medium-, and long-term impact adjustment policies have produced on these informal financial networks.

In this paper, we propose to analyze certain effects of the adjustment policies implemented in the African countries on informal financing arrangements. This paper requires that the purpose and the methodology selected first be set forth:

1) Each of the terms must be made explicit.

- Non-institutionalized credit may be defined as "a totality of legal financial activities and transactions which are not, however, officially recorded and regulated, and which fall outside the sphere of the official financial institutions" (Chandarvakar, 1988, p. 1).

Several common features make it possible to characterize the non-institutionalized networks: the predominance of cash transactions, the absence of record-keeping and regulation, the restricted scale of transactions, the ease of entry, the exchange of assets outside of legal frameworks, and a mode of operation which relies on personal relationships or feelings of inter-dependence within communities.

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Adjustment has become a polysemous term; it is used sometimes to mean stabilization, or, in a contrary acceptance, structural changes which generate growth. The term may broadly be defined as the process through which an economy adapts itself to the international environment, or, more precisely, as the way in which the balance of payments recovers equilibrium following a disruption. Strictly defined, it is differentiated from stabilization (limitation of total demand), and corresponds to growth in production, to the encouragement of exports, or to a processus of substituting for imports.

Structural adjustment may be defined as: "the lasting adjustment of the balance of payments obtained by means of the adaptation of the economic structures (mainly structures of production); i.e., by means other than a reduction in economic growth or by increased or excessive recourse to external capital".[1] The implementation of adjustment policies is based on structural or sector-based adjustment loans (SAL), which are "loans granted for the purpose of supporting an in-depth reform of the policies and institutions of developing countries, in order to enable them to bring current-account deficits down to more tolerable levels in the medium term, while at the same time pursuing the greatest possible efforts on behalf of development."[2] As compared with projects, SALs are characterized by specific features: rapid disbursement, their macro character, non-allocation for a predetermined purpose, and their link with the implementation of economic policy programs (conditionality).

2) The study of the impact of adjustment policies on the informal financial networks encounters three major methodological obstacles:

- An information problem: Despite several recent World Bank studies (1987) and the research programs of the OCDE's Center for Development (1987-89), information systems are extremely inadequate to the task of learning about the generalized effects of adjustment programs. These latter refer to macroeconomic indicators and to standard models designed according to the Keynesian national-accounting aggregates or balances framework, or to the monetarist viewpoint of monetary-financial balances, from which social indicators are absent (nutritional balances, employment, income, health or educational status), as well as the organizational and management indicators, social structures, and redistribution procedures. The available studies of informal finance give discrete cross-sections of the subject at given moments; these results do not make it possible to link finance

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[1] Guillamont (1986).

[2] World Bank (1986).

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dynamics to the adjustment process. The informal networks are, by definition, poorly observed.

- A problem of the delimitation of the adjustments, both spatially and over time. Adjustment is a process whose effects extend over several periods. It entails social transition costs. It provides a response to imbalances in the current accounts, and, most frequently, to economic and financial crises. It becomes henceforth important to distinguish the origins, either in the structures or economic conditions, of the economic and financial imbalances; the domestic or external manifestations of the imbalances, since adjustment measures aim at a restructuring of the economy and at a reallocation of resources; and adjustment loans, which make possible access to foreign credits. Monetary and fiscal policies reduce demand or domestic credit in the short run; other measures which attempt to change the expenditures structure and reallocate resources, produce effects only in the medium term, while organizational and institutional reforms may have an effect over the long term.

- A problem of attribution. Certain effects on the informal financial networks are attributed to the macroeconomic adjustment policies. Now, the links do not emerge directly. Adjustments made during the 1980s occur in the context of the reversal of the financial flows, of high real interest rates, and of depressed prices of commodities. Conversely, adjustment programs are a means to obtaining access to foreign credits and to restructuring debt payments. In the absence of experimentation which is impossible in the social sciences, three methods are generally used: compare the situations of countries which have, or have not, adopted adjustment policies; study the growth of the economies before and after the adjustment program; and assess the divergences between the announced objectives and the results obtained.

In this paper, we will distinguish between:

I - The dynamics of the informal financial networks; and

II - The ambiguous effects of adjustment policies on these dynamics.

I. THE DYNAMICS OF THE INFORMAL FINANCIAL NETWORKS

Financial-circuit dynamics are built on very old traditional forms; however, they appear to have been energized by the breakdowns of the official financial networks.

A. The inadequacy of the financial systems when confronted by development

In the vast majority of African countries, the desired rate of growth and the rate of savings exceed the financing capacity of savings. Financial markets have been developed to a slight extent. The call for external financing promotes the role of the Central Bank and the Development Banks. The greatest portion of the population is excluded from institutional finance.

1. On the one hand, the institutional financial system is geared solely toward the large organizations and the most solvent representatives.

Development Banks have open lines of credit enabling foreign sponsors to finance private-sector investments. A deterioration in their financial situation may today be observed, as well as transactions which do not fit in with their normal professional activity (credit on real property or on consumption).

Commercial Banks give greater importance to short-term credits (commercial, import/export, and campaign credit), while providing insufficient medium- and long-term financing (refusal of risk, burden of legislation and regulation, volume of bad debts).

The Central Bank, which provides the framework for credit, generally holds bad debts from the State.

2. On the other hand, the largest portion of the rural and urban population is excluded from institutional finance and resorts to "informal" networks.

Informal finance is characterized by the personalization of relationships (cf Lelart, 1984). It avoids pre-established legal requirements. Management costs are reduced to a minimum, and there is no fixed framework and no supervision.

B. The heterogeneous nature of non-institutional financial structures

Informal practices differ significantly among the countries. Community savings and/or credit groups, which are highly developed in West Africa, are, on the other hand, less developed in East Africa and Madagascar.

A distinction must be observed, in particular:

- between egalitarian and hierarchical organizations;
- between organizations whose ultimate purpose is investment and organizations engaged ultimately in consumption or social protection;

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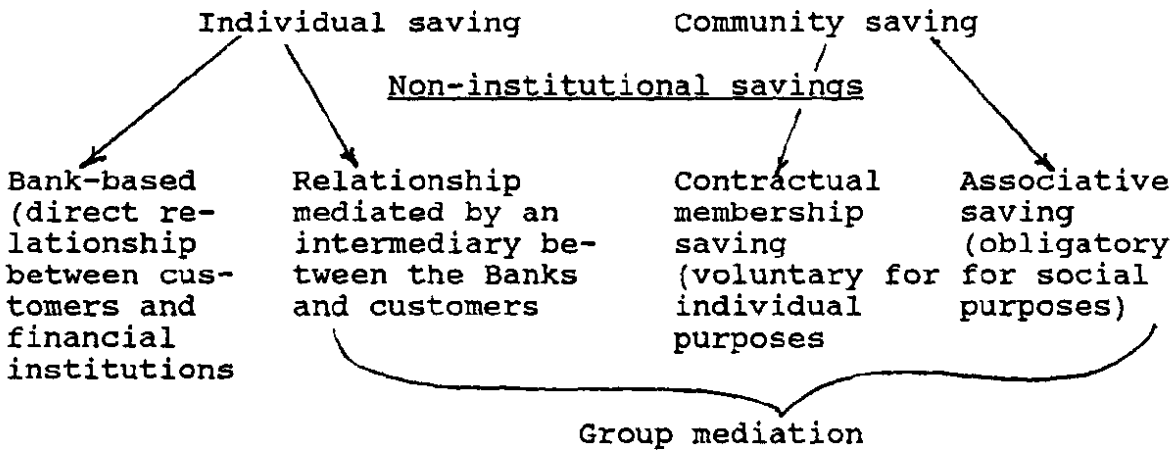
- between voluntary groups (societies) and communities or associations having forced saving.

To simplify, we will distinguish three kinds of collection, savings, and/or credit bodies (cf. Dupuy, 1989):



1. Savings Associations based on community solidarity

Associative groups are defined by the recognition of a collective consciousness and by the obligatory membership which becomes essential for individuals. Each member has a body of rights and obligations in his relationship with his community (cf Mahieu, 1989).

Obligations are made manifest by constraints placed on resources and by time constraints. They take the form of ceremonial obligations, transfers of incomes (especially between urban dwellers and villagers), and by lodging or guardianship in the cities. They may be evaluated on the basis of the rates of community pressure, which often represent more than 40% of monetary incomes for high social-status categories.

Obligations are tied to the acquisition of high social status (leaders) and to rights, especially to property rights and insurance through financing of future disasters.

Obligations and rights fall within the scope of a system of standards accompanied by sanctions (e.g., control through sorcery, by removal to a distance from the family tomb, etc.).

Membership in these associations cannot be compared to a creditor-debtor relationship. The other side of the contribution is not the repayment of a loan. What predominates is a rationale based on security and redistribution within the membership group. This rationale is especially strong because the surrounding world is uncertain and precarious, and because the State is incapable of providing social protection (Lespes, 1988).

2. Savings associations based on a tontine arrangement or rotating credit associations

In contradistinction to community associations, membership groups are based on individual voluntary memberships. Relationships are formed on a contractual basis. Associative ties are temporary and formed with reference to a functional objective.

The typical example is that of the tontine, entailing the pooling of funds with or without rotating loans. These mutual-credit systems are generally set up for homogeneous social groups; they apply a limitless variety of methods which are the expression of their flexibility of adaptation to the needs of the agents. In cases of access to capital by turns, there may be a rule establishing a predetermined order, a lottery, consensus, or auctioning to the highest bidder. Pooling may be accomplished on an egalitarian basis or according to variable contributions, as in the case of the Djanggi in Cameroon.

According to Mr. Lelart (1984), three types of tontines may be distinguished:

- the mutual tontine based on a rotating savings fund, in which levies benefit each of the members according to a predetermined order, which can, however, be revised. Each member may lend, borrow, and substitute a debt for a claim. Debts do not include interest; there are no intermediaries able to give a personal character to the claims. Mutual tontines affect the circulation of currency, since, at each levy, the funds collected are redistributed among the participants;

- the commercial tontine based on a fixed savings fund. It is administered by a "money guardian" who receives contribution dues and grants loans. The tontine subscribers thus perform certain banking services. Claims and debts bear interest. Deposits are more or less periodically made, and repayments may be made before the scheduled date. Financial accumulation is not always regular, but it is predominant.[3]

- the financial tontine, in which the order of the levies is put up for auction. The rationale underlying this system has the character of financial intermediation. It is particularly important to distinguish clearly between the primary market, which represents direct, collected savings, and the secondary market for interest collected on each loan; this interest is accrued and fed back into the system (Nzemen).

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[3] In rural areas of Niger (Kiari Liman), the average capital is on the order of 500,000 F CFA, while the capital required to found a financial institution is 10 million F CFA.

also 7 + 87

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Thus, there exists behind the tontine form, an extremely varied continuum which ranges from a social welfare rationale which approximates feelings of community solidarity to a financial rationale based on utilitarian calculations.

On the whole, logical arguments based on security predominate. The mediation of the tontine group increases the payment strength of each individual; the group's rationale is based not on the loan, but on the temporary contribution provided by the treasury (cf Dupuy, 1988).

To the extent that the overall risk is very high and that the future appears impenetrable, the arbitration between the financial risk assumed and the payment collected proves impossible. The high price granted at the particular moment leads not to decisions between risk and profitability, but to the relinquishing of an asset held as a guarantee of term coverage of daily needs. The interest rate does not reflect the risk premium or the opportunity cost of the liquid reserves (cf Bloy, Dupuy, 1989).

In a precarious world in which a very strong preference exists for liquidity (especially to meet the most urgent needs on which survival depends), the criterion adopted by those who give up immediate liquidity is the criterion of the rapidity of recovery of funds and of reduction in the event of pressing needs linked to the number of tontine subscribers.

3. Non-institutional lenders and private banks

In addition to the community and associative rationales, the totality of the non-institutional financial markets meets the trade rationales which fall outside the scope of official regulations and controls.

Private lenders, who are often usurious merchants, make loans out of their own capital or loans to the banking system; they do not accept deposits. They generally charge a high, indeed usurious rate of interest; on the other hand, they grant credit without collateral or legal guarantees. They are more interested in the guarantee provided by personal ties than in the ultimate use of the credit, and are characterized by a very substantial flexibility and rapidity in their disbursements. Households and in particular micro-enterprises which do not have access to institutionalized credit prefer to have capital available even at high cost, given the rationing of credit and the need for liquidity.

Private banks, which may be "money-guarding" individuals, make loans, contract loans from official networks, but receive deposits in return for payment.

Private financial societies make three-month loans.

Pre-cooperative groups drain off a portion of rural savings without credit costs (e.g., the popular funds of south-central Cameroon).

These various operations, which create flexibility and adapt themselves to the absence of agents' guarantees, are supported by a vast network of agents, messengers, and intermediaries who have connections with institutional finance.

The non-institutional financial networks must, henceforth, from a socio-cultural viewpoint, be seen to have their own rationales which are not reducible to utilitarian behavior on financial markets. However, the "informal" networks are dominated by the official networks, with certain groups of intermediaries existing at the points of articulation between these two kinds of networks.

C. The debate over the ties between the informal and formal networks

As regards their rationale, their are two conflicting interpretations: an analysis conducted in terms of market imbalance, and an analysis in terms of segmentation.

1. Financial dualism and financial repression

In accordance with an explanation based on imbalances linked to the managed economy, the existence of financial informal, or non-institutionalized, markets is explained mainly by discriminatory price measures, by the effects of "chasing out" linked to the Treasury's burden of debt to the Central Bank, and by the sluggishness of management and the operating costs borne by official institutions:

- the low interest rates charged by the official financial system lead to excessive investment from savings, thus bringing about the existence of parallel financial markets on which the high interest rates reflect the rationing of official credit.

- Treasury debt to the Central Bank, which is tied to the budget deficit and to the deficits of public enterprises, produces effects characterized by the chasing out of the private sector, especially small units, and generates dubious banks debts which oblige the banks to give primary importance to short-term loans and to substantial guarantees.

- The administrative sluggishness, managements costs, and payment delays prevent the large organizations from reaching small entrepreneurs who are productive on a small scale. These

factors create transaction costs and promote informal financial innovation.

Financial repression (MacKinnon) leads to a dualism between the official financial sector and the informal sector, which acts as a regulator and steps in to make up for the failings of the official institutions.

According to MacKinnon, four hypotheses derived from neo-classical monetary theory provoke particularly intense debate in the PVDs: the perfect operation of the markets, the divisibility of inputs and outputs, the demand for currency for transactions, and the yield from monetary reserves entailing zero social cost.

In the theory formulated by Gurley and Shaw, financial intermediaries provide for treatment of risk, and make it possible to reconcile the liquidity requirements of investors of capital and the needs of those requesting funds, who are forced to issue assets whose liquidity is low. The financial intermediaries arbitrate between risk and profitability.

In developing countries, on the other hand, financial intermediation is limited; segmented markets or financial networks lead to differentiated rates of return.

2. According to the structuralist analysis, the non-institutional networks are sensitive, on the other hand, to rationales which are not reducible to market rationales. There is a segmentation of the formal and informal networks, and arrangements entailing the subordination of the second type of network in relation to the first.

- As we have seen, the informal networks are sensitive to social rationales which go beyond a solely economic nature. They correspond to redistributive mechanisms and to intra-community transfers. Their primary goal is to ensure social protection and to meet uncertain liquidity needs. They are the expression of solidarity based on belonging to kinship groups and to ethnic or religious communities. The rules and norms linked to community membership create rights and obligations accompanied by sanctions. The rationales are based on transfers.

- While being sensitive to their own rationales, the informal networks are supplied by the official networks:

The informal networks constitute a derivation of the monetary and financial networks in which fiduciary currency circulates with increasing speed. Monetary policy thus produces effects which are diffused through these networks.

Intra-community transfers are tied to state transfers. The main part of State receipts originate in transfers of primary

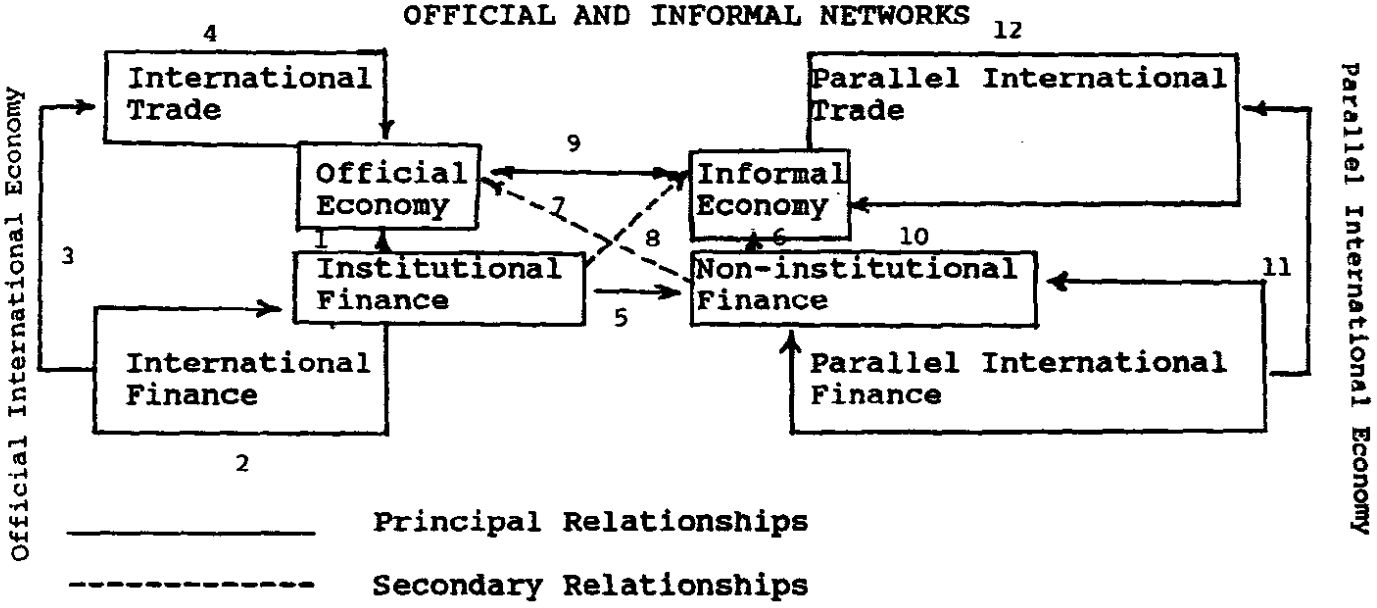
surpluses through price fluctuations. However, those who draw off income within the State follow rationales for redistribution which operate through the informal financial networks. Henceforth, the policies which modify State transfers produce an effect on the informal networks.

Finally, deposits are linked to the formation of savings tied to rural and urban incomes. Its total amount thus depends on "household" incomes.

The complexity of the relationships between the official and informal networks may be illustrated by the diagram below. 12 connections emerge tying together institutional finance, international trade, international finance, and the informal networks.

DIAGRAM 11

CONNECTIONS TYING TOGETHER THE ECONOMIC AND FINANCIAL OFFICIAL AND INFORMAL NETWORKS



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II - THE AMBIGUOUS EFFECTS OF ADJUSTMENT POLICIES

The adjustment policies put in place in more than half of the African countries since the start of the decade are responses to the extent of the financial imbalances. They are applied in the context of the drying-up of financial flows and of the reversal of these flows toward Africa.

Thanks to financial liberalization, the object of these policies is to diminish the dualism between formal and informal savings, and to make possible the creation of a savings dynamic which will permit the stimulation of investment.

In actual fact, they are implemented by players whose rationales do not always match expectations. They come within the scope of rationales for state and community transfers which are far removed from market rationales.

Financial liberalization tends to reduce the gaps between the formal and informal networks, and thus to confer formal status on a portion of the non-institutional networks. Conversely, the return to the laws of the market tend to strengthen rationales based on security, and to strengthen the preference for liquidity, both of which represent the preferences of savings groups and societies.

A. The context of the reversal of the financial conditions and of financial policies

Since the beginning of the 1980s, there has been a reversal of conditions from the viewpoint of both international financing and domestic financing.

1. During the 1970s, the international credit economy was tied to the context of disruption of the international monetary system and to the surpluses of petrodollars. This economy took the form of a high level of elasticity of international funds and by the intermediation role played by the banking system. The reduction in the relative share of public assistance and direct investment was accompanied by a very rapid increase in export credits and bank loans endorsed by States mainly to the countries having high levels of accumulation.

On the domestic level, in the majority of African countries, a reduction in the savings rate, the maintenance of investments, a growing burden of public financing arrangements, and a burden of debt owed by the Treasury to the Central Bank were noted. The budget and public enterprises deficits were financed by money creation and by the issue of securities on the domestic, and especially the international, markets.

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Monetary policy obviously varies according to country, especially between the countries of the Franc Zone and the countries outside of that zone. The first group applies greater monetary and financial rigor; however, these countries circumvented the rules by means of greater debt contracted by public enterprises and by increased resort to external financing (Guillamont).

Policies gave greater weight to low interest rates and a selection of credit for several reasons: to promote investment, avoid a situation in which credit would flow to short-term operations at a rapid rate of return, or to prevent favored treatment of foreign clients.

This policy promoted external indebtedness, which gave preference to capitalistic investment at the expense of investment of a very limit capitalistic nature. This indebtedness also produced effects of chasing out public savings in favor of private savings. The low interest increased the differentials of payment between bank credit and the usurious rates charged outside of institutionalized credit.

2. The decade of the 1980s is, on the other hand characterized by an international financial market which is less arbitrated, by the role of suction pump played by American deficits, and by the insolvency of the countries of the South. Despite the fact that a certain amount of the public assistance slack has been taken up and despite a reduction in the debt, African and Latin American countries are experiencing a negative financial transfer.

Direct investment, without exception, is not starting up again, or, in the case of Africa, is pulling out. States are no longer extending their guarantees to domestic loans. Adjustment policies are taking the form of credit control, rises in interest rates, structural reforms of the privatization of the financial system, and deregulation aiming at financial liberalization.

On the whole, the banking sector has become very brittle. Given the bad debts outstanding and the outstanding payments owed by the State or the public enterprises, the banks tend to give importance to short-term transaction entailing limited risk. The informal networks appear to be playing the role of substitute for agents whose situation is precarious.

B. Anticipated effects of the adjustment policies

The policies of adjustment implemented since the beginning have as a primary goal the encouragement of the substitution of small competitive enterprises for the large protected organizations. These policies theoretically aim at a modification of the economic structures, in order to reestablish

domestic equilibrium situations in the payments and financial balances, and, beyond that, to restructure the economic fabric so as to allow it to follow a pathway to growth without imbalances. While management of demand is the prerequisite, it is accompanied by measures for the restructuring of the supply through measures implemented with respect to prices, and also with respect to management methods or sector-based actions.

In the background, economic restructuring, liberalization, and changes in the pricing system entail modifications of the social structures and of the power relationships between the groups linked to external relations and those linked to domestic relations, between the rural and urban worlds, and between the public and the private sectors. The liberalizing undertaking aims at stimulating the emergence of innovative players and at doing away with unearned income, at reducing the scope of the parallel markets, and at introducing efficiency and rationality into resource management.

1. As a first priority, adjustment measures aim at reestablishing the equilibrium situations of the balances of payments, and beyond that, at ensuring conditions of growth.

The imbalances are explained mainly by an excess of demand over supply, by domestic discriminatory measures (managed prices, subsidies) and by external measures (excessive raising of exchange rates, control of exchange rates, protectionism). The regulated sectors are thus favored over competition-based sectors, public expenditures produce effects of "chasing out" the private sector, and redistributive objectives prevail over rationales based on production.

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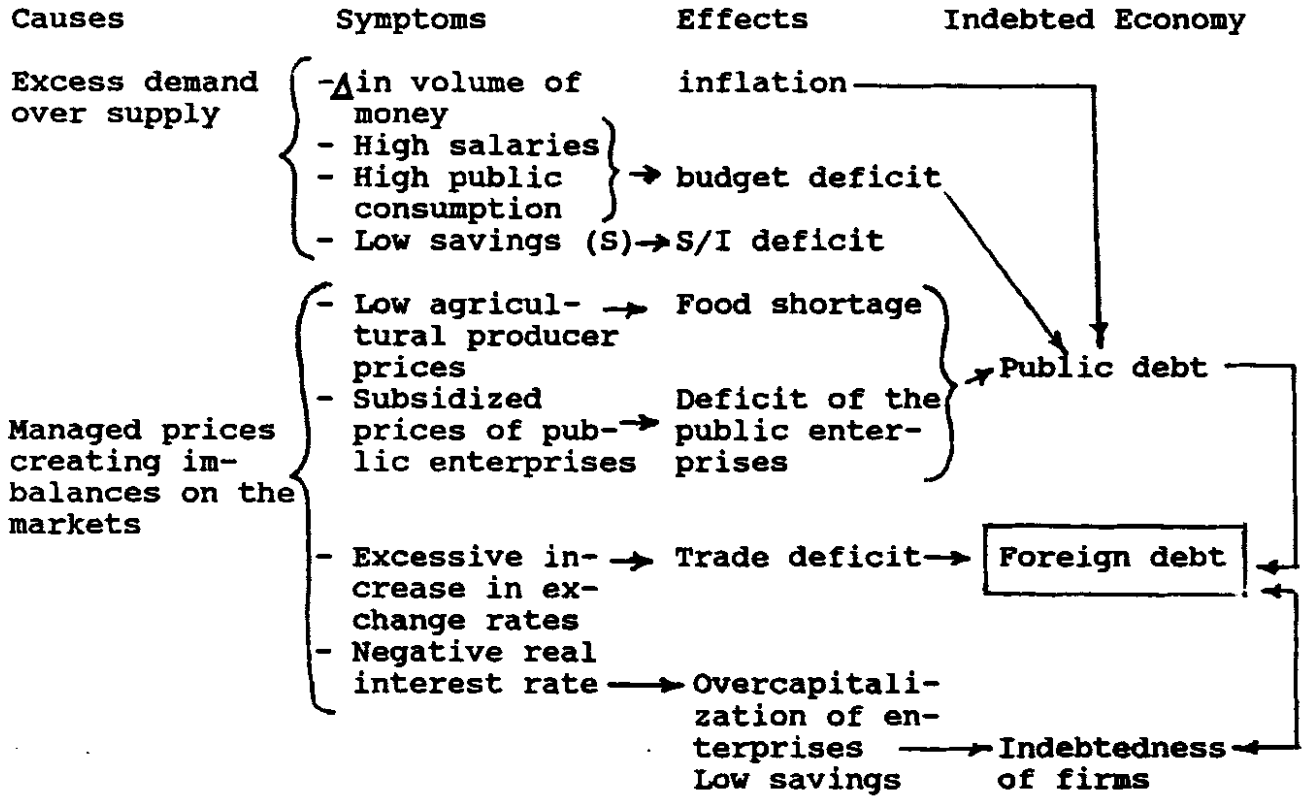
DIAGRAM 3

FACTORS CONTRIBUTING TO FINANCIAL IMBALANCES



Henceforth, the main adjustment measures will focus on:

- Opening of the world-wide market: This measure rests on the liberal principals of comparative advantage, of the free circulation of factors, and of equilibrium exchange rates. The relaxation of exchange controls and the reduction of effective protective measures approaching nominal protective levels, the absence of non-tariff protection (with the exception of the rationing of some strategic products), and the readjustment of monetary parities constituting supplemental measures should avoid sector-based imbalances and shift the terms of exchange and the non-tradable productive resources of the regulated sectors toward the competitive ("tradable") sectors.

- Domestic liberalization: The main institutional reforms aiming at the restoration of the "laws of the market" bear on the liberalization of trade, the reduction of the State's role, the removal of "fat" from public and semi-public enterprises, and the recourse to privatization. Deregulation must entail the dismantling of protective arrangements, of subsidies, and of stabilization bodies. The rationalization and the privatization of the public sector must make possible great efficiency and

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eliminate the effects of the public sector "chasing out" the private sector.

- Reduction and restructuring of expenditures: The reduction of absorption (real-flows perspective) or of domestic credit (monetary perspective) must reestablish the equilibrium of the external-accounts balance at the expense of the domestic balance. There must also be a reallocation of expenditures: reduction of the production of the protected sectors and the increase of the productivity of the export sector. This restructuring of demand through the totality of macro and sector-based measures must be accompanied by loans granted to rebuild the competitive sectors (structural adjustment loans). Thus, the rise in agricultural prices is presumed to effect a transfer of income from the city toward rural areas and lead to an exportable surplus and rural savings. Emphasis is also placed on the fight against poverty and problems arising from the redistribution of income. As a complement to the correction of financial imbalances, growth must result from an increase in the overall flows of capital, both public and private. The coordination of investors of funds and the universal extension of assistance should make possible, in particular, the maintenance of a flow of positive transfers between each of the countries.

It is presumed that the totality of these measures will reduce the unearned income and the protective arrangements enjoyed by certain privileged groups (income based on foreign trade, subsidies to protected groups: students, civil servants, military personnel, urban salaried workers). It must foster the emergence of innovative players from civilian society. To the extent that public expenditures were supposed to favor the middle classes (cf Pfeffermann, 1987), the reduction in these expenditures must necessarily affect them first and foremost.

The revaluation of agricultural prices, the restructuring of channels through structural adjustment loans, the provisional rationing of the level of food imports, and the elimination of consumer subsidies must lead to a reallocation of resources to agriculture and from the urban to the rural worlds (changes in terms of exchange).

The measures are an attempt to reduce income linked to the State apparatus and to foster the emergence of innovative groups in the private sector and in the informal sector. The model is that of average producers (farmers of the green revolution or small/medium size enterprises).

2. Financial repression measures bear in particular on restrictions imposed on the external sector, on the profitable tax treatment of tangible assets, on monetary policy, and on increased interest rates. These factor result in foreign investment and a strong preference for liquidity.

Financial Liberalization

TABLE I
ARGUMENTS IN FAVOR OF FINANCIAL LIBERALIZATION

FINANCIAL "REPRESSION"	FINANCIAL LIBERALIZATION
Analysis	
Favorable role of real negative interest rates	Favorable role positive interest rates on savings
Financial dualism linked to structures	Unity of markets due to absence of discriminatory arrangements
Investment creates savings	Savings finances investment
Separation of savings/credit: depositors do not benefit from credit tied to their deposits. Credit create deposits.	Deposits create credit.
Policy	
Inflationary transfer and selective credit policy	Disengagement of the Treasury and rigorous monetary policy
No payment on household deposits	Only household financial assets should be paid
The non-monetized economy and the scarcity of liquid assets implies a decentralization of policy. Pools of savings may not be mobilized.	Monetize the economy and create networks through decentralization. Opportunities to mobilize idle capital.
Financial structures are preconditions for financial monetary policies.	A rise in interest rates makes financial innovations possible.
Coverage criteria and quotas: quantitative rationing	Criterion of profitability: rationing by means of prices

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- According to the dualist conception, there are pools of savings which can be mobilized by a financial liberalization policy. The raising of interest rates, the reduction of transaction costs, the reduction of public-sector "chasing-out" effects, privatization, bank competition, and the elimination of various imbalances linked to the managed economy should stimulate savings and reduce, and indeed, eliminate, the differences between the official and informal markets.

3. Measurements of the stimulation of savings

The measures concerning money creation and interest rates are presumed to be preconditions for the establishment of the financial structures and to the introduction of financial innovations.

- The Keynesian therapies which predominated during the 1970s recommended forced savings through an inflation which modifies the distribution of income in favor of categories characterized by a strong tendency toward saving.

The monetary orthodoxy presumes, on the contrary, that inflation produces consumption effects, especially in favor of urban dwellers who have strong propensity to consume and import. Reduced inflation would thus increase the savings rate.

- The reduction of budget deficits and of the financing of the deficit arising from financial transactions undertaken by the State through the indebtedness of the Treasury to the Central Bank should reduce the "chasing-out" effects private savings by public savings.

- The rise in interest rates should remunerate deposits, promote a better allocation of resources, and avoid over-capitalization. By making the financial institutions more profitable, it should promote their expansion and, therefore, make it possible channel a portion of the savings placed in the informal networks through the banks.

- Deregulation should reduce transactions costs which accompany joining the official system.

- Policies of exchange adjustment linked to the preceding measures should reduce the flight of savings to external markets and restrict the informal inter-African or international networks.

The totality of these measures should thus make it possible to approximate efficient financial markets and reduce the dualism between the official and informal sectors.

Policies differ in the countries belonging to the Franc Zone and in those outside of this zone. In the first group, the policies stipulating greater monetary rigor and limits to the Treasury's indebtedness to the Central Bank restrict inflation. On the other hand, external indebtedness and the debt of public enterprises is a more important factor in these countries.

C. The Observed Effects of Adjustment Policies on Financial Networks

1. Financial Results Indicators

Since the start of the 1980s, a rise in interest rates has been observed; however, with the exception of Burundi and Mauritius, real interest rates remain negative.

	1986 Interest Rates	Annual Inflation Rates 1980-1986
Gambia	17	50.8
Kenya	11.25	39.8
Madagascar	11.5	17.8
Somalia	14	45.4
Tanzania	8.5	21.5

Source: Assidon, Jaquemot (1988)

In the various countries in which adjustment has been applied, a pronounced reduction of the expansion of liquid assets has been noted. Thus, in the UMOA countries, after a phase of expansion of liquid assets (1975-79), then a phase of stabilization and of a restrictive monetary policy accompanied by a significant deterioration in external position and acceleration of the net indebtedness of the national treasuries to monetary institutions (1980-84), the period 1984-88 has been marked by a strict limitation on credit to the economy in conjunction with a tight budget policy and a policy of restriction of imports.

According to the World Bank Report (1988), in comparison with the African countries which did not adopt adjustments during the 1984-86 period, the twenty-five countries adopting reforms experienced a growth rate of 0.8%, as compared with a rate of -4% between 1980 and 1984. The countries not implementing reforms had a decline of -2.5%.

The rates of growth in real investment and in assistance were higher in the countries adopting adjustments.

The main indicators of restoration of financial balance reflect:

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- the reduction in the pace of inflation;

- the continuation of the domestic saving-investment deficit, but at a lower level;

- the continuation of the budget deficit as a percentage of the gross domestic product (7.2%), but at lower levels of expenditures and receipts, and a change in the expenditures structure linked, in particular, to the explosion of public debt;

- a worsening of the current balance of payments as a result of a reduction in trade deficits (tied to the fall in imports), but to an explosion in debt-service costs.

The devaluations have not had the anticipated balance-restoration effects (cf Jacquemot, 1988):

- in 14 countries lying outside of the Franc Zone, nine countries have been observed in which there is a decline in exports in terms of constant value and a negative elasticity between exports and the real exchange rate;

- in 5 out of 13 cases, devaluation has produced negative effects on public finances by increasing expenditures (particularly through public debt) at a rate greater than the rise in receipts (Ghana, Malawi, Madagascar, Sudan, Zambia);

- devaluation has produced inflationary effects. In ten cases out of fifteen, the coefficient of inflation/exchange-rate elasticity has been greater than 70%.

The financial effects of the adjustment programs must obviously be judged over the long term. They imply a series of measures which are taken progressively, while their efficiency emerges only through the complementary nature of the effects they produce (policy package).

The programs are put in place under unfavorable international conditions, under which the African indicators indicate a marginalization in world trade, a decline in per capita income, and an explosion of the external debt and of the debt service.

It appears, however, that the restoration of financial balances are limited within a context of economic decline, and that, in the majority of cases, they occurs by means of adjustments at the bottom: decline in imports, investments, and budget expenditures.

2. Changes in Savings

After having fallen sharply during the year 1980-85, the savings and investments rates seem to have stabilized, and indeed to have increased between 1985 and 1987.

The decline in consumption in favor of savings has resulted mainly from changes observed in the petroleum-producing countries in 1987. On the other hand, in countries eligible for AID assistance, the domestic savings rate remains close to what it was from 1980 to 1985.

Investment has declined in real terms, especially in petroleum-exporting countries. In AID-eligible countries, real investment has stagnated; more than half has been financed from external savings.

	ASS	Petroleum Exporters	Eligible for AID Assistance
Savings rate			
1985	13	15	7
1987	14	20	7
Investment rate			
1985	12.2	10.3	14.3

Source: World Bank, 1989

- Change in Public Savings

Public savings have been directly affected by devaluations and foreign debt. There have, indeed, been public revenues derived form foreign trade (flat-rate tax levied on private-sector cash reserves), but especially further rises in the service on the public, guaranteed debt.

- Change in Private Savings

Private household savings have shrunk because of the decline in salaries and urban income.

On the other hand, the cash-flow of exporting units has tended to increase.

- Changes in External Savings

A marked decline in export revenues (more than 50% in eight years and in imports (more than 40% has been observed during the

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1980s. After having declined, the current deficit reached 10 billion dollars in 1987. Half of this deficit was financed by gifts and direct investment, and half by medium- and long-term loans producing debt.

Using Niger as an example, the budget deficit (not including finance costs on gifts) was brought down from 10.6% of the gross domestic product in 1981 to 4.1% in 1987. The reduced budget deficit due to external debt service went from 9.4% of the gross domestic product in 1981 to 0.4% in 1987. This balance was achieved because of a decline in public investment expenditures. The budgetary investment rate went from 17.8% of the gross domestic product in 1981 to 6.6% in 1987. In addition to the mining shock, Niger suffered the effects of the 7% depreciation of the value of the naira in relation to the F CFA, thus giving rise to an imported deflation and a loss of competitiveness.

D. Changes in the Informal Financial Networks

In the absence of substantive information making it possible to link the adjustment process to the dynamics of the informal financial networks, it is possible describe certain sequences and illustrate using several cases.

1. Some Perverse Effects

It is important to take into account the multiplicity of rationales underlying informal finance as described above, and to analyze the effects of overall policies on the secondary networks.

The rise in interest rates and the overall credit policy have tended to reduce the discriminatory arrangements favoring large units and the public and semi-public sectors; they tend, therefore, to eliminate gaps between the networks by conferring official status on the informal networks.

These measurements have, however, been made in a context in which the debt burden over-determines the domestic financial networks. These measurements have also led to making financial resources scarcer, resources which supply the informal networks:

- the public finances crisis reduced state transfers and the incomes of civil servants as sources of intra-community transfers;

- the limiting of credit affects the tontine-based networks.

As Mahieu writes (1989): "Community calculations and the resulting transfers (therefore) play a decisive and preeminent role in microeconomic calculations in Africa. An adjustment policy, whatever its theoretical foundations, which forgets this

problems and lays the blame solely on the State and the differences in incomes, risks to worsen the instability of this type of economy" (p. 22).

One may thus conclude that the security-based rationales having a social-welfare purpose have tended to gain increased currency at the expense of financial rationales. Conversely, however, agents who were initiators of intra-community transfers have often found it impossible to fulfill their obligations.

The effects of liberalization may thus run counter to the predetermined objectives, given the obligatory transfers, the precautionary rationales, and the redistributive priorities. Thus, the reduction in permanent revenues (e.g., salaries) or in social expenditures may strengthen transfers within community associations or promote tontine-based networks at the expense of recourse to banks.

Trade liberalization may strengthen the role of the trade intermediaries who operate between the official and informal networks; on thee other hand, however, the reduction of credit may have a retroactive effect on the lack of liquidity in the informal networks

2. Several African Examples

- In Cameroon, according to B. Hibou's study of Douala, the overall crisis has produced a contagion effect on the informal sector. This sector tends to become concentrated on the fringe which meets basic needs, and to see its activities expand on the fringes of legality.

The tontines have been partially revitalized by the crisis and by a transfer of state social protection to informal arrangements. A reduction of bank savings favoring the tontine networks may be noted; however, it is the tontines bringing together small contributions of capital which have been the beneficiaries. The liquidity and insolvency crisis experienced by the majority of households has also led to a withdrawal of investments by the tontines because of the marked preference for liquidity under conditions of pronounced shortages.

- In Ivory Coast, according to the study conducted by Mahieu and Odounfa, the evolution in the income gaps between rural and urban dwellers, calculated based on relative prices, was strongly disrupted by the changes in the intra-community transfers from urban to rural dwellers. The marked inequalities of income (the richest fifth possess nearly 62% of income) are traditionally mitigated by redistributive mechanisms. While the system of rights and obligations had become adapted to political centralization, to growth, and to urbanization, it appears to be called into question under conditions of prolonged deflation.

- In Niger, according to Cerdi's study, adjustment has proved beneficial in particular to the parallel informal network, and a pronounced de-officializing of the economy. Several reasons for this emerge: this sector is more attracted to importable good than is the modern sector; it obtains its supplies in Nigeria at the parallel price; it has made up a refuge sector in the face of the loss of competitiveness of the modern sector in which costs have become inflexible. On the other hand, according to Oudin's study, the financing of the informal sector is supplied by personal savings, by loans, and to a very slight extent by bank loans or tontines. The de-officialization of the economy has not, it appears, favored the de-officialization of financing.

- In Madagascar, where savings groups and associations have not been widely developed, vulnerable groups which are facing a marked decline in standards of living have adopted survival strategies entailing changes in behavior with respect to the family group, work, consumption, and savings.

With respect to the family, a pronounced increase in family instability (temporary or final separation), the deterioration of cohesive patterns (e.g., family meals), an increase in the commercial work engaged in by women or children who thus abandon domestic duties, and a trend toward fewer births.

The search for minimum income leads to the proliferation of small-scale activities which increase the length of time devoted to work and which give importance to monetized income. It also takes the form of a pronounced intensification of migratory movements.

Two opposing phenomena emerge within the context of migratory movements: one the one hand, insecurity and the lessening of nutritional opportunities have opened the way to rural emigration and exacerbated differences among the farming community; on the other hand, there are instances of urban emigration linked to crises in rice supplies in the cities. While, traditionally, migrations were mainly inter-urban, and while limited rural emigration took place in stages and focused above all on small urban centers, a profound change has been observed. The total rural exodus rate of 12% in 1975 was estimated to be 29&in 1985. Intra-rural, urban-rural, and rural-urban migration has increased.

Two survival strategies may be distinguished:

- Regressive survival strategies are characterized by the recourse to illegal or alegal practices: criminal behavior, prostitution, child abandonment, child labor, and theft in urban settings; brush fires, thefts or standing harvests or cattle thefts in rural settings.

- Tolerable adaptation strategies are characterized by the search for complementary resources, reduction of consumption, withdrawals from savings or patrimony (land, cattle). The complementary resources result from the sector termed informal, from indebtedness, from multiple occupations, from work, from family members and from migration. The adjustment of consumption is carried out by means of superfluity, but also on the basis of food consumption. Households grow proportionately; marriage is postponed, and there is also a trend toward stepping back from family cohesion. Emphasis on social differentiation in rural and urban environments leads to an exacerbation of the tendency to reduce people to the proletarian condition, and to the concentration of patrimony (especially with respect to land and livestock).

In Conclusion: What Support Policies for the Informal Networks?

Policies favoring informal networks must rest on existing dynamics, through incentive policies. They must create a favorable environment and provide answers to problems organized hierarchically by the actors.

Taking Existing Dynamics into Account

The behavior-based rationales we have discussed must be integrated and reoriented by incentive policies, in order to take into consideration the economic rational dictating the reduction of risks to the minimum and the strong preference for liquidity leading to diversification of activities and a very short-term burden. According to a development rationale promoting the long term, support policies must reduce risks and encourage financing; for example, operating capital would be borne by small units, ownership of fixed capital being ensured by investors, along with the establishment of a leasing system for small producers. The dynamics of the informal networks is bounded by kinship relationships and by solidarity networks. We must focus our efforts not on individuals, but on groups, and take into consideration their various organizational methods.

- The Creation of a Favorable Environment reduce risk - - -

The external environment must be stabilized to reduce the precarious nature and the vulnerability of small-scale activities. Relationships of complementarity with the dominant economy must be forged through a stabilized solvent demand or by the furnishing and accessibility of inputs and equipment, whether these are used for production or for household uses.

- Formulate Specific Support Policies

- Policies must be specific to the country and to the type of activity. The dynamics are endogenous; it is possible to add to them, to encourage them, but not to substitute for them. In this sense, comparisons between experiences are illuminating for information purposes or as comparative methods, but not as the basis for transposing them.

- Policies must take into account the very great heterogeneity of the situations: access to credit must thus distinguish the cases in which the actors have no need of credit or in which they have no recourse to it; cases in which usurious networks are broken up by means of access to credit for consumption for the poorest people; cases in which the informal mechanisms for the mobilization of savings (e.g., tontines) may be oriented toward credit for investment; and, finally, cases in which new systems of financial intermediation must be put in place to link the financial institutions with the vast number of small productive units.

- On the whole, policies must incite to action. It is of course possible to apply one's efforts directly to certain target groups, for example to the most dynamic agents linked to modernization procedures (metalworking, repairs, etc.); however, policies must basically work instead on the environment, at the level of incentives which appeal to the professionalism of groupings, of relationships forges within channels, or of the stabilization of the environment.

- Policies must organize hierarchically the various bottlenecks: access to credit, technologies, the demand problem, management problems, etc. Experience shows that all of these factors work in combination. To have access to credit, to change scale, to modify the tools, means to change the mode of organization and often to increase risks in an unstable and uncertain universe. Henceforth, if one wishes to further a process of accumulation linked to the reduction of multiple activities, it is important to stabilize the environment as regards both outlets and prospects and access to supplies or groupings based on professional considerations.

To form places of interface between the organizations and official institutions and the micro-enterprises. since the current distance separating the two systems is of a nature which is socio-cultural as much as economic and financial. The principle underlying these places of interface is that of the joint participation of micro-units and large institutions:

- In the area of credit, mutual guarantee companies and solidarity-based financial guarantee companies must make possible access to credit for the small-scale units without a patrimony

which would permit extension of collateral (e.g., the SIDI). Changes in banking practices can also make possible access to credit for the poorest people (e.g., the Grameen Bank) (cf. Mr. Nowak, 1988; Mr. Yunus, 1988; Chandavarkar, 1988).

- In the area of <u>means of production</u>, locations for storage and leasing of raw materials and spare parts or small equipment and technical catalogs must promote accessibility and basic technical innovations.

- As regards <u>training and management</u>, service providers may meet needs upon request.

- The access to <u>information</u> and to technology must make it possible to improve techniques and productivity at all levels and promote a range of technology making possible the replacement of human and animal energy by mechanical energy, or to economize on firewood for meal preparation.

Finally, <u>stabilization</u> and the maintenance of <u>solvent demand</u> are priorities. These factors may be provided through the public markets by means of micro-enterprise components in the context of projects financed with external assistance, or through the formation of subcontractor networks within industrial systems.

success but
flexibility + social rules

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DRAFT

INFLATION IN AFRICAN COUNTRIES

Joshua E. Greene 1/

Since the period of the first oil shock in the mid-1970s, African countries have experienced a considerable amount of inflation. Inflation rates of 20 percent or more a year have been common for many African countries during the past 15 years, and a few countries have even experienced rates in excess of 50 or even 100 percent a year. The persistence of inflation has had significant repercussions for African countries, affecting economic performance in a variety of ways. The financial sectors of these countries have felt a significant impact. However, other macroeconomic aggregates--consumption, savings, and investment--have also been affected, as have foreign exchange markets in some countries with particularly high inflation rates. Despite the awareness that Africa has an inflation problem, there is remarkably little analysis of the phenomenon to date. 2/

This paper provides an analysis of the inflation problem in Africa 3/ during the period since 1974. Section I reviews recent trends

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2/ Among the few papers are Chhibber et al. (1989), Rwegasira (1979), and Rwegasira (1989).

3/ Throughout this paper South Africa is excluded.

in inflation in Africa, examining the data both for individual countries and for groups of countries with relatively high and more modest inflation rates. Section II examines the possible causes for inflation, focusing on the different contributions of monetary expansion, fiscal deficits, exchange rate adjustments, and other factors to inflation in high- and moderate-inflation countries. Section III then turns to a brief discussion of the effects of inflation on the financial sectors of African countries. The discussion in this section is necessarily somewhat speculative, since most of the available information is of a qualitative and anecdotal nature. Section IV of the paper discusses various policy measures available for reducing inflation in African countries and what their possible effects could be on the financial sectors of these countries. Section V contains some concluding remarks.

I. Recent Trends in Inflation in African Countries

Official price data for most African countries must be evaluated with caution, for a variety of reasons. In many countries price indices record prices only in the capital city or urban areas, and the weights attached to various components have not been revised in many instances for several decades to reflect changes in consumption patterns. In addition, price indices often reflect the official prices of goods subject to price controls, rather than actual prices of goods as sold in popular or rural markets.

Despite these provisos, it is clear by all accounts that African countries have experienced significant inflation since the period of the first world oil price shock in the mid-1970s. According to the data in

the Fund's most recent World Economic Outlook (WEO) exercise (IMF (1989)), the rate of consumer price inflation in Sub-Saharan Africa, as measured by a weighted average of individual country data, averaged more than 20 percent a year during the period 1981-88 and significantly exceeded that level during 1981, 1983-84, and 1988 (Table 1). For all of Africa (excluding South Africa), inflation rates in certain years have been almost as high as those for Sub-Saharan Africa, with the period average being about 17 percent. As shown in Table 1, since 1981 Africa's inflation rates have averaged somewhat less than those for all developing countries, largely because the figures for developing countries as a group reflect the heavy weight of high-inflation countries in Europe and Latin America. Inflation rates of African countries have been somewhat higher, on average, than those of developing Middle Eastern countries (16 percent), about twice those for developing countries in Asia (9 percent), and three to four times the average for industrial countries (5 percent). At the same time, African inflation has averaged less than that of developing European countries (29 percent) and far below the average rates experienced by developing countries in the Western Hemisphere (119 percent).

A closer look at the data in individual African countries indicates that the average inflation rates of 17 to 20 percent largely reflect the experience of a smaller group of countries with very high inflation rates. As indicated in Table 2, inflation rates in a group of 12 countries with inflation rates of 20 percent or more during at least 4 years since 1980--Ghana, Guinea, Guinea-Bissau, Mozambique, Nigeria, Sierra Leone, Somalia, Sudan, Tanzania, Uganda, and Zambia--have averaged nearly 27 percent a

Table 1. Inflation Rates in Africa and Other Country Groups, (1971-88) 1/

	Average 1971-80 2/	1981	1982	1983	1984	1985	1986	1987	1988	1989
Africa 3/	15.2	22.4	12.6	19.7	23.8	12.4	13.2	14.7	19.8	17.2
Sub-Saharan Africa 4/	17.2	25.7	14.0	24.5	29.4	13.4	14.2	18.2	24.9	20.4
Developing Countries	20.5	25.8	25.2	32.4	38.2	39.7	31.1	40.5	67.1	37.0
By Region:										
Asia	10.5	10.4	6.4	6.7	7.3	7.1	9.1	9.8	14.6	8.9
Europe	13.8	23.6	33.1	22.8	25.4	25.5	24.8	30.3	49.3	29.1
Middle East	13.5	15.1	12.9	12.0	14.4	17.0	18.2	19.3	18.8	15.9
Western Hemisphere	39.8	60.8	66.8	108.6	133.0	144.9	87.8	130.0	277.6	118.6
Industrial Countries	8.7	10.1	7.5	4.9	4.7	4.1	2.3	2.9	3.2	4.9

Source: IMF (1989).
1/ Annual percentage changes in consumer prices, as reported by Fund member countries.
2/ Compound annual rates of change.
3/ Excludes Angola, Namibia, and South Africa.
4/ Excludes Algeria, Angola, Morocco, Namibia, Tunisia, and South Africa.

Table 2. Inflation Rates in Selected African Countries, 1975-88 1/

	Average 1975-80	1980	1981	1982	1983	1984	1985	1986	1987	1988	Average 1981-88
High-Inflation Countries	26.6	21.9	33.4	14.5	31.7	39.4	15.8	17.9	26.2	37.0	27.0
Ghana	61.3	50.1	117.4	22.1	123.1	39.7	10.3	24.6	39.8	31.4	44.8
Guinea	11.6	40.0	35.0	29.9	30.3	26.0	19.0	68.4	36.8	27.8	33.5
Guinea-Bissau	16.4	64.8	45.5	16.5	23.3	65.0	45.0	37.0	106.7	66.0	48.4
Mozambique	2.0 2/	2.0 2/	2.0 2/	18.6	28.1	30.3	29.2	38.7	166.0	50.1	39.6
Nigeria	19.8	10.0	20.8	7.7	23.3	39.5	5.5	5.4	10.2	32.9	17.5
Sierra Leone	15.0	12.9	23.4	26.8	68.6	66.6	76.6	80.9	178.7	37.4	64.5
Somalia	21.8	59.0	44.6	22.6	36.4	92.3	37.7	35.7	28.1	82.2	45.7
Sudan	20.1	26.5	24.0	26.6	30.6	33.7	45.6	23.3	19.5	41.2	30.3
Tanzania	16.4	30.2	25.6	29.0	27.0	36.2	33.3	32.4	29.9	25.1	29.8
Uganda	77.3	99.2	108.5	49.4	24.1	40.5	126.8	179.6	256.0	123.0	101.7
Zaire	60.8	46.7	35.4	36.3	77.1	52.2	23.8	45.7	90.4	82.0	53.7
Zambia	14.3	11.7	14.2	12.3	19.7	33.0	34.2	51.6	57.0	50.1	33.0
Above Countries Excluding Nigeria	37.6	41.3	56.0	27.9	50.2	39.1	38.7	44.4	56.4	44.8	44.9
Other Countries											
Africa 3/	11.5	10.6	12.3	10.6	6.1	9.4	9.3	9.3	6.1	8.2	9.2
Sub-Saharan Africa 4/	12.8	11.5	11.5	12.8	10.4	11.1	9.9	8.7	6.4	8.7	9.9

Source: IMF, April 1989 World Economic Outlook; and staff updates.

1/ Annual rates of change in consumer prices.

2/ Staff estimate.

3/ Africa as defined in Table 1, excluding high inflation countries.

4/ Sub-Saharan Africa as defined in Table 1, excluding high inflation countries.

year since 1975. Except for Nigeria, all of these countries have experienced inflation rates in excess of 30 percent during most of the 1980s, with the average for 1981-88 more than 40 percent once Nigeria is excluded. In Sierra Leone and Zaire the average inflation rate during 1981-88 exceeded 50 percent a year. In Uganda, the average was more than 100 percent a year, with inflation exceeding 120 percent annually during 1985-88. As shown in Table 2, inflation accelerated noticeably in many of the high-inflation countries during 1986. Inflation accelerated further in 1987 and then receded somewhat in 1988. These trends are masked to an extent by the heavy weight given to Nigeria in the composite figures shown in Table 2. In Nigeria, inflation remained fairly modest between 1985 and 1987 (averaging 7 percent per year) and then accelerated to more than 30 percent in 1988.

Inflation rates for the remaining African countries were significantly lower during 1975-88, averaging about 12 percent a year during 1975-80 and 9 percent during 1981-88, the latter being about twice the rate for industrial countries during the same period. The comparable figures for the Sub-Saharan component of moderate-inflation African countries were 13 and 10 percent, respectively. Nevertheless, twenty-one of the thirty-five moderate inflation countries in Sub-Saharan Africa experienced at least one year of 20 percent inflation during the 1975-88 period: Burkina-Faso, Burundi, Cape Verde, Chad, Comoros, Cote d'Ivoire, Djibouti, Equatorial Guinea, Ethiopia, Gabon, the Gambia, Kenya, Madagascar, Malawi, Mali, Mauritania, Niger, Sao Tome and Principe, Senegal, Swaziland, and Togo. Of these, eleven countries experienced inflation of 20 percent or more in two or more years, and six (Cape Verde,

Equatorial Guinea, the Gambia, Madagascar, Mali, and Niger) had inflation rates of at least 20 percent in three or more years, including at least two consecutive years. Three countries had inflation rates above 20 percent for four years in the period: Cape Verde (1975, 1981-83), Equatorial Guinea (1982-85), and the Gambia (1975, 1985-87). Only one of these countries, the Gambia, had an inflation rate averaging more than 15 percent a year during the period, although the Gambia's inflation rate for the entire 1975-88 period was still smaller than that of any of the countries in the high-inflation group.

II. Factors Responsible for Inflation in African Countries

A variety of factors have been responsible for inflation in African countries. As noted in a recent World Bank study of inflation in Zimbabwe (Chhibber *et al*. 1989), the mechanisms giving rise to inflation in individual countries are complex, frequently involving a combination of monetary and cost-push factors, and are influenced by exchange rate developments and changes in price control regimes. Nevertheless, recent theoretical and empirical work on inflation has identified at least three models, not necessarily independent, for explaining the acceleration of inflation in individual countries. One is a straightforward monetarist approach. The second, which can be termed a "fiscal" approach, acknowledges the role of money in inflation, but identifies large fiscal deficits as the underlying cause for monetary expansion. The third approach focuses on the role of exchange rate depreciation, either in conjunction with monetary policy or as an influence on other factors feeding into inflation. In addition to these three approaches, claims

have been made for other variables as factors behind the rise in African inflation rates, including increases in import prices and increases in domestic incomes, through higher wages and agricultural producer prices.

First, and perhaps best known, of the various inflation theories is the monetary approach. This reflects Milton Friedman's well-known adage that "inflation is always and everywhere a monetary phenomenon." According to this view, inflation should be positively correlated with rates of monetary expansion, with the most inflation-prone countries experiencing the largest rates of monetary growth. Moreover, as monetary growth can come from various sources, it is the monetary growth that matters, rather than underlying factors that may be responsible for it.

The second approach attempts to look behind simple monetary/inflation correlations to identify the source of monetary expansion in large fiscal deficits. As summarized in a recent paper by Montiel (1988), proponents of this view note that the equilibrium inflation rate ultimately depends only on the ratio of the fiscal deficit to GDP. Since fiscal deficits have been relatively large in many African countries and tighter fiscal policy is invariably an element when African countries undertake adjustment programs, this "fiscal" model is also appealing.

The third theory of inflation emphasizes the contribution of the balance of payments, and particularly the exchange rate, in generating price increases. In this approach, exchange rate depreciations are seen as contributing to inflation either through an increase in inflationary expectations or a worsening of the government's budgetary position that is later accommodated by monetary expansion. Alternatively, depreciations may augment inflation by speeding the process of adjusting nominal wages

and, thus, domestic prices. 1/ Although this latter explanation may be more relevant to countries with formal wage indexing systems, it may also apply to countries with very high inflation rates, in which public sector wage rates are often adjusted following large devaluations.

In addition to these three theories of inflation, two others more reflective of the old "cost push" and "demand pull" models of inflation have been advanced. One emphasizes the role of higher import prices, an important "cost-push" element that can increase domestic prices both directly and through its effect in raising the cost of domestically-produced manufactures. The other stresses the role of wage increases and increases in farm incomes, the latter being measured by movements in agricultural producer prices for major crops, as a source of inflation. This view is reminiscent of more traditional "demand-pull" models.

This paper does not attempt to build a formal model of inflation in African countries, such as that in Chhibber et al. (1989), or to undertake a formal test for the relevance of alternative inflation theories, as is done in Montiel (1988). Nevertheless, some initial conjectures can be drawn by comparing data on inflation for high- and moderate-inflation countries with movements in potential explanatory variables, such as the rate of monetary growth, the fiscal deficit to GDP ratio, trends in import prices, and movements in composite nominal effective exchange rates, the latter being a measure of changes in national currencies vis-a-vis a set of country trading partners and trade competitors. These data,

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1/ See Montiel (1988), pp. 2-3.

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drawn from IMF (1989) and the Fund's International Financial Statistics data base (for nominal effective exchange rates), appear in Table 3.

The data in Table 3 provide strong support for the role of monetary expansion in generating inflation. African countries with high rates of inflation have tended on average to have faster rates of monetary growth during the post-1974 period than have African countries with lower inflation rates, even though money growth was not necessarily faster in the high-inflation countries every year. During 1981-88 the average yearly growth rate of broad money in the high-inflation countries approached 26 percent, nearly twice the rate in other African countries. This general pattern can be seen in Figure 1, which provides a scatter diagram of inflation and monetary expansion for the high-inflation and other African countries throughout the 1975-88 period. Indeed, the simple correlation between price inflation and monetary expansion in these two groups of countries was 0.63. Of course, the relationship between monetary expansion and inflation may reflect other factors, such as the rate of domestic credit expansion, particularly where net foreign assets have been static or declining. Because of limited time, these other factors have not been explored in this paper, however.

There does not seem to be the same close relationship between inflation and fiscal deficits per se, as recorded in the WEO, or between inflation and the rate of import price increases in foreign currency (measured in U.S. dollars). For example, central government budget deficits as a percentage of GDP were actually somewhat smaller in the high-inflation countries than was true for other African countries during most of this period. This lack of correlation between inflation rates and

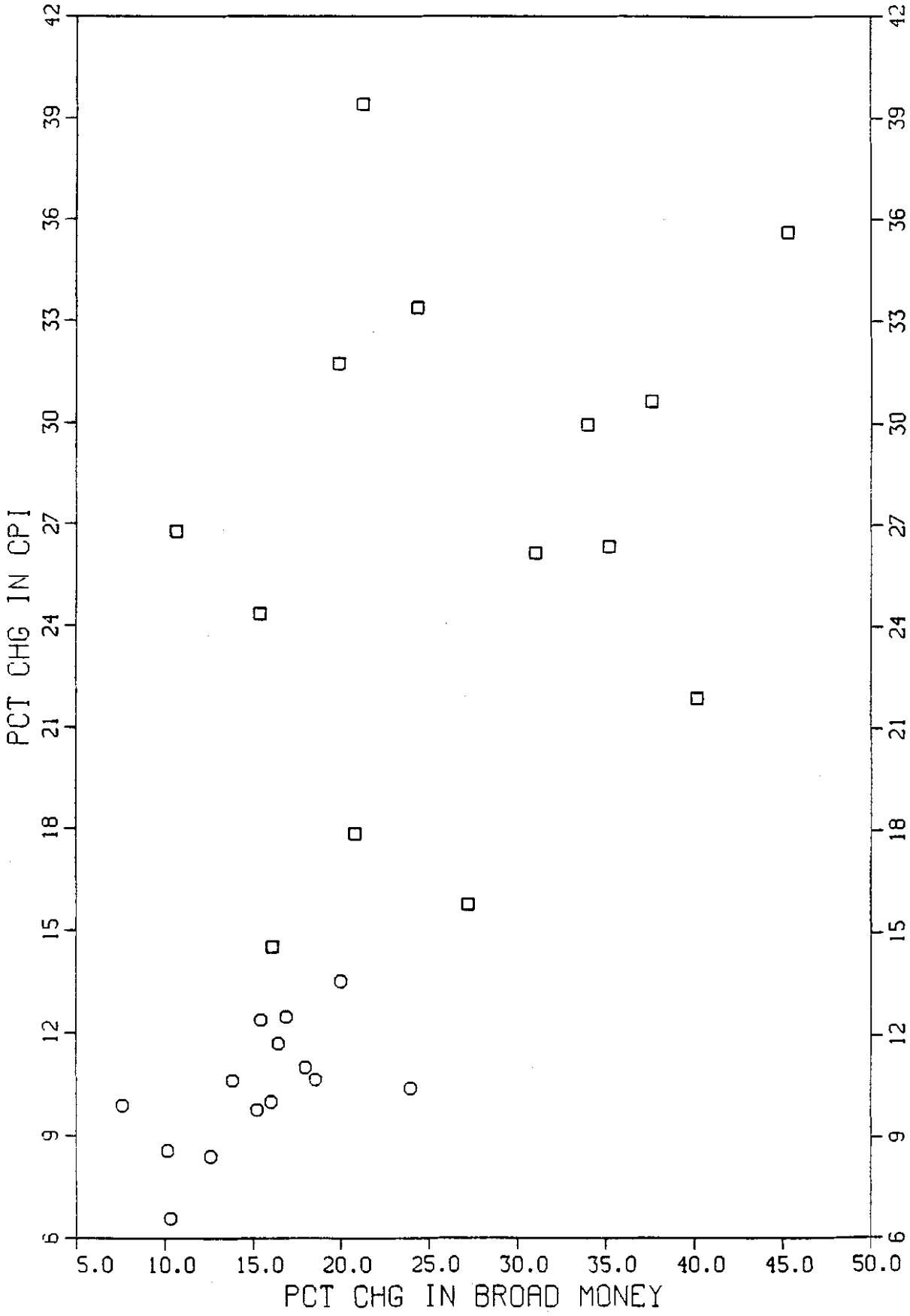
Table 3. Africa: Selected Economic Indicators for High-Inflation and Other Countries, 1975-88

	High-Inflation Countries					Other Countries				
	Inflation Rate 1/	Money Growth 2/	Fiscal Deficit 3/	Import Prices 4/	Exchange Rate 5/	Inflation Rate 1/	Money Growth 2/	Fiscal Deficit 3/	Import Prices 4/	Exchange Rate 5/
1975	30.6	37.6	9.8	12.0	..	11.1	18.4	6.8	14.8	..
1976	26.3	35.2	9.7	-0.7	..	9.9	23.8	8.5	-1.4	..
1977	30.0	34.0	8.2	9.6	-1.2	13.2	20.4	7.8	8.2	-0.3
1978	26.8	10.7	5.7	13.8	-9.2	12.3	18.1	7.3	11.9	-2.0
1979	24.4	15.4	5.0	15.6	-8.2	11.8	16.0	7.6	15.8	0.6
1980	21.9	40.2	3.6	15.7	4.7	10.6	14.0	7.3	15.5	2.2
1981	33.4	24.3	7.8	-3.7	1.1	12.3	15.7	5.4	-4.4	1.9
1982	14.5	16.1	7.7	-4.6	-1.8	10.6	18.1	8.4	-6.1	2.7
1983	31.7	19.9	8.2	-4.6	-5.8	8.1	12.7	10.0	-3.8	1.8
1984	39.4	21.2	4.8	-2.8	-6.9	9.4	16.0	6.5	-3.2	3.3
1985	15.8	27.2	4.0	-1.6	-13.2	9.3	15.1	6.8	-1.5	2.3
1986	17.9	20.8	4.9	13.5	-43.3	9.3	6.6	8.2	13.0	-7.1
1987	26.2	31.0	9.5	10.9	-59.9	6.1	9.9	7.4	10.7	-6.1
1988	37.0	45.3	9.5	6.2	-18.6	8.2	9.8	7.8	5.1	-4.6
Averages:										
1975-80	26.6	28.7	7.0	11.5	-3.5 6/	11.5	18.4	7.6	10.8	0.1 6/
1981-88	27.0	25.8	7.0	1.8	-18.5	9.2	13.0	7.5	1.3	-0.7

Source: IMF, April 1989 World Economic Outlook.

1/ Percent change in consumer prices.
2/ Percent change in broad money (M_2).
3/ Central government budget deficit as a percentage of GDP.
4/ Percent change in import unit values (in U.S. dollars).
5/ Percent change in nominal effective exchange rate; negative figure indicates depreciation.
6/ Average for 1977-80.

FIGURE 1
AFRICA: PERCENT CHANGES IN CPI AND
BROAD MONEY, 1975-88

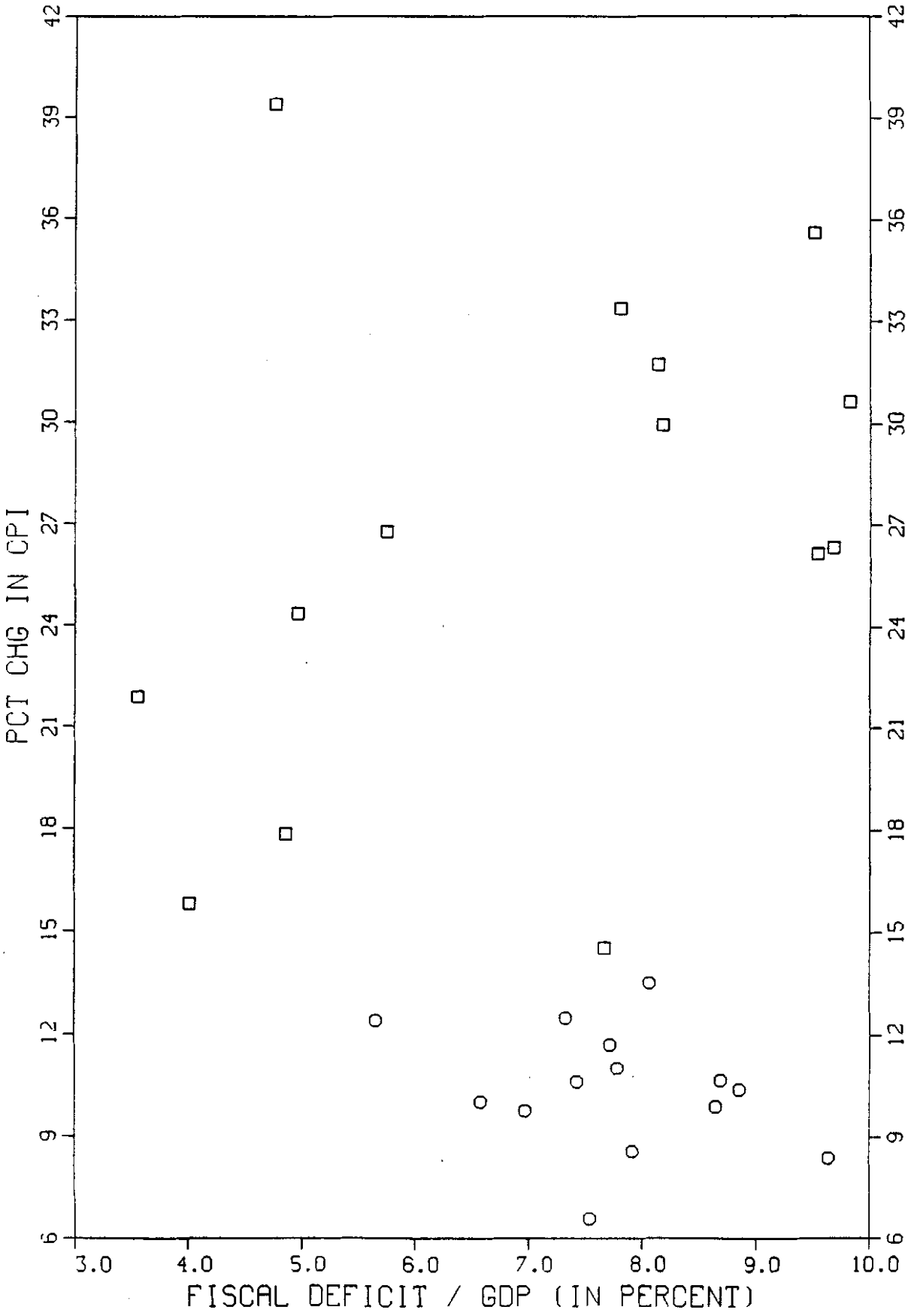


□ HIGH INFLATION COUNTRIES
○ OTHER COUNTRIES

fiscal deficits could be because the data available reflect only central government fiscal deficits, rather than deficits for the entire public sector, for which information is not readily available. It could also be because the same budget deficit may have very different inflationary repercussions depending on its financing, and some WEO data suggest a more rapid increase in credit to government in the high inflation countries. Thus, the data do not support a purely "fiscal" (as opposed to a credit to government) explanation for inflation in African countries, and a scatter diagram for inflation and central government fiscal deficits in these countries (Figure 2) shows no clear relationship between the two variables. There is also little support for the role of import prices as an underlying source of inflation in African countries. According to Table 3, import prices rose slightly faster in the high-inflation countries than in the rest, but the difference averaged less than 1 percentage point. Again, a scatter diagram for import prices in foreign currency and the domestic inflation rate (Figure 3) shows no clear relationship between the two variables.

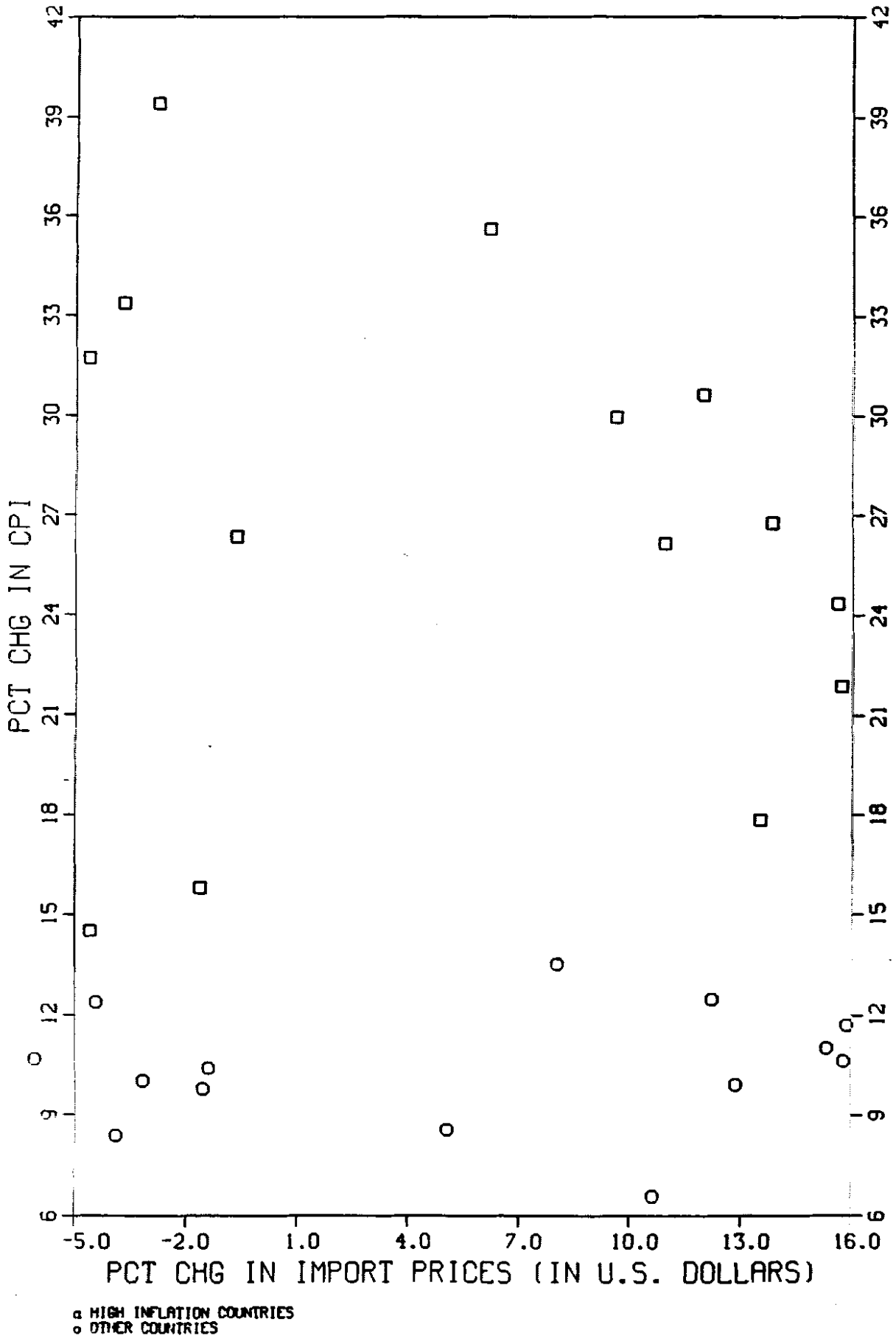
There is a strong, contemporaneous relationship between exchange rate depreciation and the rate of inflation in African countries during the 1981-88 period, although this need not imply that the direction of causality is from depreciation to inflation. As measured by nominal effective exchange rates, the average annual rate of depreciation in the high inflation countries was 18.5 percent, and exceeded 20 percent a year for ten of the twelve countries in the group. By comparison, the average rate of depreciation was only 0.7 percent for the moderate inflation countries, and 0.6 percent for the subset of these countries in Sub-

FIGURE 2
AFRICA: PERCENT CHANGE IN CPI AND
FISCAL DEFICIT AS A PERCENT OF GDP, 1975-88



□ HIGH INFLATION COUNTRIES
○ OTHER COUNTRIES

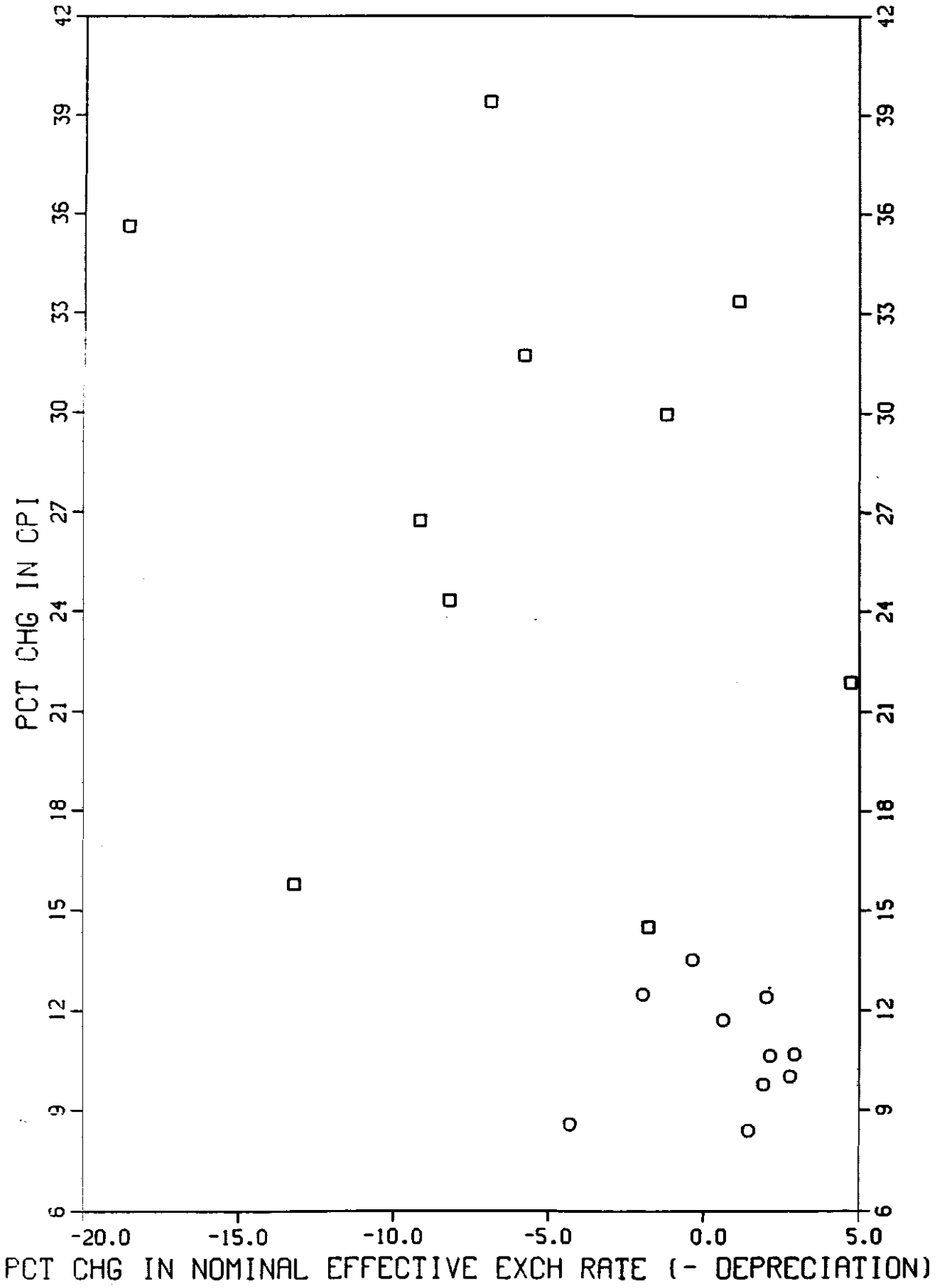
FIGURE 3
AFRICA: PERCENT CHANGES IN CPI AND
IMPORT UNIT VALUE, 1975-88



Saharan Africa. In only two of these countries was the average rate of depreciation above 10 percent during the period, and only one (Equatorial Guinea) had an average rate of depreciation as high as that of countries in the high inflation group. Moreover, after excluding two years (1986 and 1987) when depreciation was unusually large in the high-inflation countries, the simple correlation of inflation with depreciations in the nominal effective exchange rate for these two groups of countries is 0.53. Thus, the data are consistent with exchange rate movements being related to inflation in African countries, which is also consistent with the results in Montiel (1988). This can also be seen from the scatter diagram of inflation and movements in the nominal effective exchange rate for both high-inflation and other countries in Africa, which appears in Figure 4.

Despite these observations, the precise relationship between exchange rate depreciation and inflation is complex. In many of the high inflation countries, depreciation occurred only after several years of rapid monetary expansion, high inflation, and a decision by the government either to adjust the official exchange rate (as in Ghana, Tanzania, and Uganda in 1987 and 1988), or to allow the rate to float, either temporarily (as in Zambia) or permanently (Zaire). In some cases the government did so in response to the growth of widespread parallel exchange markets, which had developed in response to continuing monetary expansion and the subsequent overvaluation of the official (fixed) exchange rate. In these situations exchange rate adjustment may well have been a response to other, more fundamental sources of inflation, rather than an immediate cause. On the other hand, exchange rate adjustments themselves raise the domestic prices of imported goods, which in turn

FIGURE 4
AFRICA: PERCENT CHANGES IN CPI AND
NOMINAL EFFECTIVE EXCHANGE RATES, 1977-85 AND 1988



affects the overall inflation rate. Indeed, in some countries where foreign exchange is extremely scarce and most current account transactions occur on the parallel exchange market, there may even be a more direct link between the parallel exchange rate (sometimes reflecting prior monetary expansion) and the overall consumer price index. Indeed, there have been cases, such as Uganda in May-June 1987 and Mozambique in late 1988, where a depreciation of the official exchange rate in conjunction with other adjustment policies has contributed to a temporary appreciation of the parallel market rate and a temporary reduction in some consumer prices. Thus, more detailed analysis is needed to specify the precise role of exchange rate depreciation in generating inflation in African countries, in particular the extent to which inflation, as part of a vicious cycle involving monetary expansion and other factors, has acted as an independent cause in African countries. 1/ Current empirical research on this issue is inconclusive. 2/

Although data on wage rates and farm incomes or producer prices are not readily available for groups of African countries, there is some evidence that wage movements have contributed to inflation in Africa, if

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1/ There is an extensive theoretical literature on the interaction between devaluation and inflation. See, for example, Rodriguez (1978), Bilson (1979), Bond (1980), and Khan and Lizondo (1987).

2/ Chhibber et al. (1989), in their analysis of inflation in Zimbabwe, find that the exchange rate, acting through the price of imported goods, had a positive but statistically insignificant effect on the domestic inflation rate once certain institutional relationships involving food and service prices had been taken into account. Similarly, Harber (1989), in his analysis of inflation in Zambia, found monetary expansion rather than exchange rate depreciation the proximate cause of inflation during the period of its foreign exchange auction, 1985-87. On the other hand, Montiel (1988) has determined that initial exchange rate movements were an important and identifiable cause of hyperinflation in Argentina, Brazil, and Israel.

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not as initial cause then as a factor facilitating inflation in response to other developments such as exchange rate depreciation. Countries that have experienced large, discrete devaluations have often observed major, subsequent increases in wage rates that have subsequently boosted aggregate demand and reinforced inflationary trends already underway. Similar effects may have occurred in countries with severe foreign exchange shortages and limited supplies of domestically manufactured goods following increases in agricultural producer prices. In the case of Uganda, for example, following the May 1987 devaluation wage increases in the private and public enterprise sectors were especially pronounced, raising local food prices and negating the gains in real income from the across-the-board wage increases granted to civil servants. In some countries the resulting increases in consumer prices have led to substantial appreciation in the real effective exchange rate, undermining competitiveness and creating pressure for further exchange rate depreciations. Indeed, the inability to restrain wage increases following a devaluation has sometimes led to a vicious cycle of devaluation and wage adjustments whose ultimate effect has been a continuing inflationary spiral, much as in countries with formal indexation systems.

III. Impact of Inflation on the Financial Sector in African Countries

Research on the effects of inflation on the financial sectors of African countries has been very limited, and only a few general conjectures about these effects can be offered in this paper. Most of these are drawn from the author's experience in Uganda, Zambia, and other

countries in eastern Africa and may not necessarily be generalizable to other countries. More systematic research regarding these conjectures is therefore desirable. Nevertheless, these observations may be more broadly applicable insofar as they result from important rigidities in the financial sectors of African countries, in particular the reluctance of many African countries to set or adjust nominal interest rates so that real rates (nominal rates less the currently expected rate of inflation) are positive.

Certainly one effect of inflation on the financial systems of African countries is a tendency for residents to economize on the use of money. This can be seen in Table 4, which reports a number of monetary indicators for both high-inflation and other African countries. As a whole, the velocity of money in the high inflation countries is significantly higher than that in the other African countries, with the average for the former group being one and a half times that of the latter during 1981-88.

A second consequence of inflation that arises in the context of negative real interest rates is a persistent excess demand for credit from the private sector in many African countries, particularly for short-term ventures. This process has been aided by the prevalence of overdraft financing in many countries, an inheritance from British banking practice, as the normal format for business credit and by the reluctance of commercial banks to make medium- or long-term commercial loans. Where the expected inflation rate exceeds nominal interest rates, borrowing for certain types of private ventures becomes very attractive, particularly where scarcities of consumer and other goods allow private firms to revise product prices frequently. These same forces encourage consumers to

Table 4. Africa: Selected Monetary Indicators for High-Inflation and Other Countries 1/

	High-Inflation Countries			Other Countries		
	Velocity 2/	Quasi-Money Share 3/	Growth in "Real" Private Credit 4/	Velocity 2/	Quasi-Money Share 3/	Growth in "Real" Private Credit 4/
1975	4.44	0.23	...	3.77	...	...
1976	4.46	0.23	97.2	3.47	0.19	...
1977	4.11	0.22	28.9	3.31	0.20	67.6
1978	4.45	0.21	53.6	3.13	0.21	207.9
1979	5.09	0.22	23.8	3.10	0.21	18.7
1980	4.43	0.23	56.4	3.17	0.22	-4.9
1981	4.41	0.22	63.8	3.11	0.23	183.8
1982	4.42	0.25	113.7	2.99	0.23	110.8
1983	4.46	0.24	-59.8	2.99	0.23	54.5
1984	4.23	0.23	107.4	2.84	0.24	-24.7
1985	4.05	0.24	501.1	2.73	0.25	-21.7
1986	3.96	0.22	105.8	2.62	0.25	-13.5
1987	4.51	0.24	12.9	2.59	0.27	37.8
1988	4.02	...	...	2.58	...	...
Average: 1975-80	4.50	0.22	52.0 5/	3.33	0.21	72.3 6/
1981-88	4.26	0.23 7/	120.7 7/	2.81	0.24 7/	46.7 7/

Sources: IMF, International Financial Statistics; and IMF, April 1989 World Economic Outlook.

1/ Data represent averages for country groups weighted by a three-year moving average of country GDP in U.S. dollars

2/ Ratio of GDP to broad money (M2).

3/ Quasi-money (time and savings deposits) as a percentage of broad money (M2), excludes Nigeria.

4/ Percent change in end-of-year private sector credit divided by percent change in end-of-year consumer price index.

5/ Average for 1976-80.

6/ Average for 1977-80.

7/ Average for 1981-88.

spend, so as to avoid future price increases. Accordingly, private savings are discouraged, and firms may prefer to stockpile consumer goods or other real assets in place of financial assets as a way of maintaining financial reserves. Where inflation is virulent and real interest rates are highly negative, the share of time and savings deposits (i.e., quasi-money) in broad money may also decrease, as private parties economize in general on their use of cash balances. Table 4 provides some support for this during 1984-87, although for the entire 1976-87 period the percentage of quasi-money in broad money was fairly similar in high-inflation and other African countries, once data for Nigeria (a high-savings country) are excluded. 1/

A third consequence of inflation on the financial sector is an increased desire by banks to make short-term loans. The reason is that governments in most African countries fix interest rates and provide commercial banks with significant spreads between deposit and lending rates. By confining themselves to relatively safe activities, such as normal trade finance and seasonal financing of large agricultural concerns, commercial banks can earn significant nominal profits on short-term lending operations even where real interest rates are highly negative. This helps to explain the steady growth in the volume of private sector credit in countries with high inflation rates and interest rates that are substantially negative in real terms. Indeed, as Table 4 indicates, during 1981-88 Africa high-inflation countries have on average

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1/ This measure is somewhat flawed as a savings indicator because only savings at commercial banks are included. Data to examine trends in savings across banks and non-bank institutions were not readily available for a large number of African countries.

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exhibited somewhat faster rates of growth in credit to the private sector, after allowance for inflation, than have countries with lower inflation rates.

A fourth consequence of inflation on the financial sector has been a reduction in loan losses, particularly as regards commercial lending. Where inflation is marked, borrowers can repay old debts in much cheapened currency, thereby reducing the real cost of debt service. Defaults and loan losses therefore decrease. This, in conjunction with guaranteed spreads between the cost of obtaining and providing funds, provides further impetus for short-term commercial borrowing, thereby raising the growth rate of credit to the private sector. In Uganda, for example, rapid inflation during the mid-1980s largely eliminated loan losses as a serious concern for the commercial banks by early 1988, thereby increasing the willingness of the banks to meet the commercial sector's demand for credit. At the same time, inflation has probably not strengthened the balance sheets of commercial banks, because the real value of their assets as well as their liabilities has eroded.

A fifth consequence of inflation for the financial sector has been a shift in lending toward shorter-term activities, particularly those in sectors capable of benefiting from inflationary trends. Given the uncertainties arising from inflation, borrowers are more likely to seek funding for short-term ventures offering relatively secure returns, thereby avoiding riskier propositions that may require more time (and greater short-term financial outlays) to turn profitable. In countries with volatile exchange rates and high inflation, there may be a move into short-term speculative activities, such as the stockpiling of imported

goods or of agricultural commodities in anticipation of future price increases. This, for example, was the case in Uganda during 1987 and the first half of 1988, when rapid inflation and the extreme scarcity of consumer goods enabled merchants to earn large profits on sales of imported consumer durables, while coffee brokers accumulated large loan balances during certain times of the year by holding coffee in anticipation of subsequent increases in official producer prices. On the lending side, commercial banks become more reluctant to undertake medium- and long-term commercial loans, as foreseeable returns are much higher on safe, shorter-term loans. Overall, therefore, there is a tendency towards shorter-term lending, together with some shift in lending activities toward low-risk ventures yielding smaller real returns over the long run.

IV. Policy Responses to Inflation and Their Effects on the Financial Sector

During the last decade a number of African countries have attempted, with varying success, to reduce inflation through the implementation of economic adjustment programs. Many of these programs have been supported by financial assistance from the Fund and the World Bank, and there is evidence that countries making strong efforts at implementing these programs have in fact achieved significant reductions in their inflation rates.

Reducing inflation is an important aspect of economic stabilization that can benefit national economies in a variety of ways. Financial systems in particular stand to gain, especially where (as in Africa) institutional rigidities make it difficult for interest rates to reflect the real cost of capital, thereby subsidizing borrowing and discouraging

financial savings. In the transition to a more moderate inflationary environment, however, the financial sector of a country may experience some difficulties, particularly as borrowers adjust to a new economic environment in which real interest rates are less highly negative and fiscal and monetary policy are made more consistent with the country's available financing. Some of these problems are worth mentioning here, although they should be recognized as transitional costs rather than as reasons for not undertaking economic stabilization.

First, banking sector activity is likely to decrease, particularly where national authorities use outright ceilings on the growth of private-sector, as well as public-sector, credit as the instrument for achieving the monetary and credit objectives incorporated in a Fund-supported adjustment program. This, in turn, may reduce banking sector profits, at least in nominal terms. On the other hand, the reduction in total loan volume may be accompanied by an improvement in total banking assets, as the volume of loans profitable only at highly negative real interest rates declines.

Second, lower inflation rates may contribute to higher loan losses, particularly where the slowdown in inflation is accompanied by recession and greater business difficulties. Accordingly, banks may be less willing to extend credit in some cases and may need to retrench so as to strengthen their capital base, particularly where stronger bank supervision is part of an adjustment program. In some situations the adverse effects on private sector activity may be such as to make a significant percentage of private sector loans non-performing, thereby jeopardizing the soundness of major elements of the commercial banking

sector. This, in turn, may necessitate government financial support to individual banks. The requisite government expenditure needed for this support must then be taken into account when developing fiscal policy and setting goals for credit to the public sector.

On the positive side, with less inflation banks may be more willing to lend for longer-term activities, as the uncertainty and financial risks attached to them decrease relative to the returns from shorter-term ventures. It may therefore become easier for borrowers to finance longer-term capital investments offering a greater chance of improving output and productivity at their enterprises. In short, there may be less lending overall, but more funds available for investment, and particularly for projects that stand a chance to increase national output and strengthen the balance of payments over time.

Where higher interest rates are part of the adjustment program, a variety of consequences may follow, some of which may appear unfavorable to the financial sector as the economy adapts to a more realistic set of price incentives. On the positive side, higher nominal interest rates that raise the real rates on deposits and lending will reduce the incentives for speculative short-term borrowing while increasing (at least relatively) the incentives for financial saving. The quality of loan portfolios should improve as a result, and savings deposits may increase. At the same time, however, total loan demand and the volume of private sector borrowing are likely to decrease, possibly reducing bank incomes. Higher interest rates may also impose financial losses on firms, particularly those selling commodities whose prices are fixed by government order. Public enterprises, which are common in many African

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countries, are particularly likely to bear the brunt of higher interest rates (although they were also benefitting from the previous regime of more negative real interest rates), and the resulting losses (or increases in losses) may translate into higher budgetary subsidies and greater government demands for banking credit.

Few African countries have experimented with eliminating interest rate ceilings and reducing reserve requirements. However, the experience of Argentina and Chile with these types of reforms suggests that they carry risks if not implemented in the context of an effective bank supervision system. Particularly where financial markets are thin and there is a perception that governments will intervene to prevent bank failures, interest rate liberalization can encourage commercial banks to increase the riskiness of their loan portfolios, especially where a sharp rise in interest rates crowds out loan applications for safer but lower-yielding investment projects (Le Fort, 1989). Adequate bank supervision is needed to counteract this tendency. In many African countries, thorough supervision is hard to maintain, given the shortage of trained personnel, limited government resources, and often relatively low salary levels for highly-skilled government workers. Accordingly, support and perhaps technical assistance in this area may be important in minimizing the transitional costs for the financial sector from implementing an economic stabilization and adjustment program.

Regarding financial savings, the rise in real interest rates should generate some increase. In practice, however, the impact may be small or uncertain. Research to date on savings behavior in developing countries has found little evidence to support a strong interest-rate sensitivity of

private savings. 1/ This may reflect a variety of factors, including a lack of suitable savings instruments and the availability of more attractive alternatives, such as foreign assets or investments in nonfinancial assets, to agents with resources available for savings. Accordingly, it may be optimistic to hope that increases in interest rates, particularly small increases that leave real rates highly negative, can generate significant increases in private savings. Thus, most of the benefits from higher interest rates are likely to come from their impact on lending activity, rather than the level of savings.

V. Summary and Conclusions

During the last fifteen years African countries have experienced a fair amount of inflation. During 1981-88 the inflation rate has averaged about 17 percent a year for African countries excluding South Africa and 20 percent for the Sub-Saharan countries. Among African countries a small group of about twelve have experienced very high inflation rates, averaging about 27 percent a year, with the average for the others being about 9-10 percent during the 1980s.

A variety of factors have contributed to inflation in African countries, including the effect of the first and second oil shocks and rising prices of imported consumer and intermediate goods from the industrial countries (particularly during the 1970s and in 1986-88). Monetary expansion, however, has also played an important role. There is clear evidence that rates of monetary expansion have been substantially larger on average in high-inflation African countries than in more

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1/ See, for example, McDonald (1983) and Khan and Knight (1985).

moderate inflation countries, with monetary growth averaging about 26 percent a year in the former and 13 percent in the latter during the 1981-88 period. Exchange rate depreciation has also been considerably greater in the high inflation countries, although it is hard to determine the independent effect of exchange rate movements on the inflation rate. By comparison, fiscal deficits and changes in the foreign price of imports in the two groups of countries have been roughly similar. However, there is some indication that credit to government has increased faster in the high inflation countries.

Inflation has had a number of adverse consequences for the financial sectors of African countries, effects magnified by structural rigidities. Because nominal interest rates have generally been kept low, real interest rates have usually been negative, sometimes highly so in countries with very high rates of inflation. This has encouraged borrowing, particularly for short-term trade activities, and discouraged savings. Lending for longer-term investments has also been discouraged, and in countries with hyperinflation there has been evidence of borrowing for short-term, speculative activities. At the same time loan losses have declined, which may have encouraged the total volume of bank lending.

Of the policy measures often proposed for responding to inflation, domestic stabilization policies are likely to affect the financial sectors of these countries in a variety of ways. Lower inflation may increase the demand for investment and to that extent the demand for credit. It may also make banks more willing to engage in longer-term lending, thereby facilitating investment projects yielding higher benefits in the long run. In the short run, however, greater fiscal and monetary restraint may

reduce the total volume of bank lending, thereby reducing bank profits, and by slowing private sector activity contribute to greater loan losses. Over time, however, the quality of the banking sector's loan portfolio should improve, as the volume of loans attractive only at highly negative real interest rates decreases.

Because of the prevalence of fixed nominal interest rates, raising interest rates becomes an important component of any structural adjustment program in most African countries. Increases that result in higher real interest rates provide firms with more accurate signals regarding the true cost of borrowed funds while increasing the incentives for financial savings. At the same time, higher real interest rates may have temporary, adverse consequences for the financial sectors during the transition to a more stable economic environment. Higher rates may well reduce loan demand, increase loan losses, encourage banks to finance riskier loans by discouraging safer but lower-yielding projects, and result in greater financial losses for firms, particularly public enterprises and other agencies that have benefitted in the past from the subsidies inherent in highly negative real interest rates. Greater losses experienced public enterprises could, in turn, lead to higher fiscal expenditures, if as a consequence governments make larger transfers to these companies. These various consequences should be anticipated when formulating an economic adjustment program. For example, the possible effects of loan losses on government expenditure should be taken into account in formulating overall fiscal and credit policy under a comprehensive adjustment and stabilization program. Likewise, interest rate reform should encompass increases in both deposit and lending rates,

while taking account of the spreads between these rates that banks have been allowed in the past.

Despite the possible adverse consequences in the short run, African countries stand to benefit in a variety of ways from reducing inflation. Lower inflation rates contribute strongly to an improved economic climate that fosters growth through greater stability. A low inflation environment makes it easier for firms to plan and implement new investment projects by reducing uncertainty and encourages financial savings by providing positive real returns at more moderate nominal interest rates. Lower inflation rates also reduce the costs associated with the need to make frequent price adjustments and to take precautions against future inflation. Accordingly, policies to lower inflation remain worthwhile for African countries, even though in the transition to a healthier economic environment they may have some temporary, adverse effects on these countries' financial sectors.

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THE IMPACT OF MONETARY AND FISCAL POLICIES ON THE FINANCIAL SYSTEM IN TANZANIA

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Introduction:

The growth strategies adopted by African countries in the post-independence period may broadly be categorized into two groups: a) strategies of socialist orientation aimed basically at redressing income distribution through enhanced public ownership of the commanding heights of the economy; and b) strategies along the capitalist path, marked by limited government interference with markets and gradual growth of a mixed economy with private sector dominance. The nature of macroeconomic policies, and instruments used to achieve them under the two strategies has been both practically and conceptually different. In particular, countries that embarked on socialist orientation, including Tanzania, took recourse to measures that entailed a considerable degree of direct regulation of the markets for land, labour, money (including capital) and goods. On the other hand, countries that followed the traditional mixed economy path continued to pursue policies through indirect monetary and fiscal instruments, applied to influence decentralized decision making by economic units via the markets. This divergence in the approaches to economic policy-making suggest that the impact, and indeed, the effectiveness of monetary and fiscal policies on the economy, and on the financial system in particular, will be radically different in the two groups of countries.

The objective of this paper is to evaluate the impact of monetry and fiscal policies on the financial system drawing on Tanzania's experience. We start by a brief excurss on a simple theory of financial growth in a regulated, or restricted, as opposed to a liberalized or unrestricted economy. Further, we give a brief review of Tanzanias financial system and an evaluation of its performance during 1980-1987 in terms of growth of total financial assets and its major components. The third section dwells on the weaknesses in central banking and conduct of monetary policies. Section four attempts to discuss the weaknesses in the financial institutions (other than the central Bank), special reference being made to NBC's experience. The last part of the paper presents an evaluation of the

causes of the observed financial trends and implicity presents a case for financial reform.

1. A Caricature of the Theory of Financial Growth in a Regulated Economy:

In the economic literature there is now a consensus that the growth of a sound, well-intergrated, infrastructure of financial institutions, instruments and interest rates is a necessary pre-requisite for sustainable economic development (Goldsmith, 1969, McKinnon, 1978). The financial system has two broad objectives: first, the provision of payments facilities--a responsibity that rests with the monetary system comprising the note/currency issuing authority (or the central bank) and the intermediaries that provide chequing accounts (the commercial banks). The second broad objective, which is cerfomed by the financial system as a whole, is that of intermediation in the saving-investment process, by providing savers (surplus units) and investors (deficit units) with financial instruments which have characteristics suited to their diverse saving motives. In order to meet the latter objective, the financial system must in the course of time and development of the real economy widen, lengthen and deepen.[1/]

The widening of the financial system is measured by the number of actors in it, i.e savers, investors and financial intermediaries. Financial lengtherning, on the other hand, is characterized by the number of different financial insruments traded in the market including, for instance, currency, bank deposits of all types, insurance and pension claims, corporate bonds and shares, government short- and long-term securities, mortgage certificates, and loans of various maturities given by financial institutions. Apparently, widening and lengthening are inseparable since the more diversified is the financial asset menu the more appealing it will be to the savers and investors with different preferences for the attributes of liquidity, yield, risk, divisibility and convenience combined with different weights in specific financial instruments. The overall outcome of financial lengthening and widening is deepening in finance-

1/ This ratio declined from about 9% in early 1960s to about 8% in 1980 (Kimei, 1986, p. 206 and 211

1/ Goldsmith, 1953, and Gurley and Shaw, 1955 were among the pioneering authors who provided the evidence to the proposition that financial growth was a necessary concomitant of real economic growth.

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-which indeed may result from one of the processes taken singly. Financial deepening is the growth of the relative share of financial assets in total wealth, and it is generally taken as an aggregate measure of financial development.

The growth of the share of wealth held in form of financial assets is important for two main reasons. First, it reflects an increase in the portion of aggregate savings that is allocated to investors through financial intermediaries (and thus independent of the savings units) and and in this respect indicates an improvement in efficiency of resource allocation. Second, the more short- and long -term financing is accomodated by the financial system, the more effective can credit policy be used to influence economic activity.

In the choice of financial growth strategy, countries are faced with two extreme alternatives--viz:

(i) reliance on the inherent- strength and dynamic efficiency of competitive markets, i.e. unrestricted financial growth;

(ii)centralization of financial decisions, and shape the financial underpinnings of the development stratergy by Government intervention--i.e. restricted financial growth.

The argument for allowing competitive markets in equities, bonds and money is straight forward. Competition may, in theory, be expected to accomplish all the major targets of financial development--raising the level of savings; efficiently channelling them into investments with different degrees of yield and risk; and creating an integrated credit market.

The 'Unrestricted Financial Growth Hypothesis':

The contestability of the markets for equities and debt instruments has the following theoretical implications:

(a) Aids the appearance of new types of financial intermediaries that offer an asset menu with broad selection in terms of yield, liquidity, risk, and divisibility;

(b) Widens and lengthens the markets in which investment opportunities compete for savings. This opens the way to superior allocations of loanable funds;

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(c) Drives interest rates to correspond more accurately to opportunities that exist for substituting investment for current consumption and to consumers time preference. In this regard, real interest rates are likely to be high in competitive markets, and will display a continuum array of interest rate spreads that will correspond to the differentials in risk premia attached to each financial asset in the menu;

(d) Leads to an equalization of the returns to physical and financial assets, thereby raising the rates of return to financial savings;

(e) The attendant decline in the risks of yield, liquidity and accessibility in holdings of financial assets--including money--

tend to increase monetization of the traditional subsistence sector. Moreover, the differences in rates of interest in the formal and informal financial markets tend to be evened out so that a fragmented capital market becomes more and more integrated, and

(f) The increase in domestic returns on financial savings may reverse capital flight.

The overall outcome of the foregoing effects of contestability is an increase in the ratio of domestic financial savings in total wealth (or income). The latter will relieve the government of the need to raise funds through inflation tax. The integration of the money and the capital markets pave the way for conducting monetary policy by using traditional
instruments .

Nevertheless, unrestricted financial growth is not automatically realized by the government doing nothing and pursuing a laissez-faire policy. If the starting point is, as in Tanzania, an open dependent economy, without a national central bank but with financial operations mainly in the hands of foreign foreign commercial banks, then some active government policy will be necessary to form the institutions and instruments of monetary policy and to ensure the existence of domestic competition within the financial sector. Secondly, the lack of incentives, information and experience on the part of the potential domestic investors may in reality make a fast spontaneous growth of financial markets difficult to achieve. In this

connection, the process of learning and assimilating new values and attitudes require a high degree of political patience.

Restricted Financial Growth

In a restricted financial regime, the converse of what happens in the regime that allows competition will obtain to a degree determined by the extent of regulations. The main motivations for introducing regulations into the markets has in most cases probably been the mistrust of the market in allocation of resources, the argument that markets in the less developed countries are imperfect, and attempts to keep the cost of financing the public sector deficits as low as possible.

Restrictions on financial prices, and entry and exit into the financial system, have had the effect of limiting financial widening, lengthening and deepening.

2. The Tanzania's Financial System.

Tanzania's financial structure is fairly simple, with the central bank (the BOT) and all other Banks and financial institutions (except the Diamond Jubilee Investment Trust- DJIT) being publicly owned. From 1967 until very recently, 1984, the NBC was the only commercial bank chartered to operate in the Mainland Tanzania. Over the period, the NBC managed to spread its branch network--comprising of 166 branches and 231 agencies--to different regions and districts, including one branch in Zanzibar. From 1984, the TRDB (the then specialized rural development bank) was given mandate to carry on commercial banking bussiness together with the development banking business. The Pepoples Bank of Zanzibar (PBZ) has been performing some central bank functions (with the exception of currency issuing) as well as the commercial banking operations to all parties, but has limited its business to the Islands only.

Long- and medium-term development finance is provided by the following Institutions:

i) The Tanzania Investment Bank (TIB) - for industry and large scale agriculture. The sources of funds of this institution are loans from the central government and foreign sources (including multilateral institutions--World Bank, African Development Bank etc.).

Hitherto, the TIB does not mobilize local resources by accepting public deposits.

ii) The Tanzania Housing Bank (THB): This institution provides medium and long-term loans for residential and commercial housing construction. The main sources of funds for the THB are:

a) loans from Government and foreign sources.

b) public deposits- including saving and time deposit accounts (but not demand deposits)

c) Workers and Farmers housing Development Fund - a special Fund contributed by employers to finance housing for low income employees at subsidized rates.

iii) The Tanganyika Development Finance Company Limited (TDFL):
The TDFL is jointly owned by the Government of Tanzania, the Deustche Financierings Fur Beteiligungen Entwicklungslandern GmbH (DEG), the Nederlandse Financierings Maatschappij Voor Ontwikkelingslanden N.V (FMO), the European Investment Bank, and the commonwealth Development Corporation. The institution operates more or less like the TIB-- granting loans to all sectors of the economy, except that its lendings have a bias in favour of the private sector. The funds deployed by the TDFL originate largely from external sources.

iv) The Tanganyika Post Office Savings Bank (POSB) is a savings bank, accepting savings deposits at Post Office counters all over the country, and investing them almost entirely in government paper.

v) The National Provident Fund (NPF) is a social security fund, managing all pension contributions from workers and employers. It invests a large portion of its funds in government stocks, while the remainder is loaned out on long-term basis for development projedts.

vi) The National Insurance Corporation (NIC) is a government owned insurance company with the monopoly of operating in Tanzania. The NIC conducts both the general and life assurance business. it also manages, on behalf of the government, the Parastatal Pension Fund (PPF). The NIC is aided by a network of private insurance agencies/brokers, together with the publicly owned State Insurance Brokers.

3. The Tanzania's Financial Growth in Recent Period

The perfomance of Tanzania's financial system in the mobilization and

deployment of resources in the period 1980-1987 is summarized in the financial survey (Table 1).[1/] . The financial survey includes assets and liabilities of all financial institutions. As evident from the brief of the financial institutions in the country, over the period 1973-1988 the financial system remained more or less intact, with the exception of the reconstitution of the Rural Development Financing Institution (the TRDB) into a commercial and development bank under the name CRDB in 1984. Thus, over the period of 15 years or so, the financial system did not change its degree of institutional specialization. infact, even the financial instruments available in the economy remained static over the period.

The overall performance of the financial system is assessed by the trends in the ratios of the total financial assets and the major types of financial assets, to national wealth (proxied by GDP). Table 1 clearly indicates a marked decline of the ratio of total financial assets to GDP from about 59% in 1980 to 36% in 1987. The ratio of monetary assets defined broadly to include broad money (M2) and assets of the savings bank (the Post Office Savings Bank), to GDP declined from 48% in 1980 to 34% in 1987, while non-monetary financial assets had their ratio to GDP reduced from about 11% to a mere 2% in corresponding periods. These trends suggest that both the monetary--commercial banks (including the central bank)--and the non-monetary systems retrogressed in the past eight years. For the monetary system this was a reversal of the trend registered in 1970s when there was some growth that reflected an increase in money demand on account of relatively low interest rates and inflation rates (see Kimei, 1986). For non-monetary financial sector, the fall in its assets relative to wealth in 1980-1987 was a continuation of a trend that began in mid - 1960s following restrictions on the entry into the market.

4. WEAKNESSES OF THE EXISTING SYSTEM OF FINANCIAL INSTITUTIONS

4.1 The Banking System:

1/ This ratio declined from about 9% in early 1960s to about 8% in 1980 (Kimei, 1986, p. 206 and 211

1/The performance of that sector over the period 1950-80 has been analysed by Kimei, 1986. It is shown that the period 1950-65 was one of growth in finance, while 1967-80 was marked with financial retrogression.

4.1.1 Weaknesses with Bank of Tanzania (BOT):

The main function of central banks is to conduct monetary policy, of which major objective is to maintain domestic and external monetary stability. By any standards, the BOT has not successfully performed this fundamental task -

a) inflation has been soaring (or, as others put it, skyrocketing) from 1979 onwards. Only in the recent three years has the inflationrate at least stabilized, though at a high rate of about 30% p.a.
b) the external balance of payments position has been in chaos--huge current account deficits (excluding government transfers),reachingup to about 200% of total export proceeds in 1987.

For developing countries in general, and Tanzania in particular, we consider the pre-requisites for effective control of monetary expansion to be (cf Kimei, 1986 ch.8.):

a) A tight fiscal stance, that limits the budget deficit to a low level;
b) Proper coordination of monetary, fiscal, and exchange rate policies;
c) Binding restrictions on the accessibility of the financial system to the central bank - i.e. the central bank should strictly be a lender of last rather than a first resort;
d) Effective control over the liquidity level of the financial system; and
e) A viable and efficient financial system, that encourages deposit mobilization.

Although the original BOT Act had given the central bank effective power for limiting government borrowings from it--by stipulating a statutory maximum of 1/6 of budget annual revenue--overall government bank borrowing (which is the matter in monetary expansion) was beyond control, as the government took recourse to the NBC whenever the BOT limit was approached. The amended (1978) BOT act is much more loose on the central bank's ability to limit government bank borrowing. It sets a 1/6 of budgeted revenue limit on central bank lending to government for recurrent needs, but leaves more or less open the central bank's purchase of government debt for development budget. The implication of this laxity in the amended BOT statute is that the BOT may - given the limited autonomy it has over the Treasury--be forced to accomodate the

government at a rate that might destort the attainment of desired monetary targets.

More important perhaps, is the silence of the Act on the penalties on the management of of the BOT itself for failing to comply with statutory requirements in respect to extension of credit to the government, and indeed to monetary targets stipulated in the Annual Finance and Credit Plan.

By and large, the control of domestic credit expansion in the light of the recent experience with increasing and sizeable government budget deficit requiring bank accomodation - would above all, require statutory limits to be established on government bank borrowing from both the central and commercial banks.

Bank credit demand by the non-government sectors of the economy over the past two decades was dominated by the parastatal sector. In particular, the share of the parastatal sector in the total credit extended by the NBC rose from a mere 5.5% in 1967 to 72% in 1972 and further to about 95% in 1984. Following the adoption of a financial package associated with the economic recovery program (ERP) giving emphasis on availability of credit for productive purposes (irrespective of whether they were public or private) and subsequent imposition of ceilings on credit to marketing boards, the share of the public sector took a downward trend, reaching 85% in 1988. This is a clear case of public sector crowding-out of the private sector. The effects of crowding out in the case of Tanzania are modified by the following conditions:-

i) the practice of putting ceilings on nominal interest rates; and

ii) rationing of credit by ad-hoc socio-political criteria.

According to traditional theory, an increase in credit demand by the public sector will trigger an increase in interest rates, which in turn induces financial resource mobilization, since interest rates on savings also go up. However, when the interest rates on deposits are administratively fixed the positive effect of crowding out on deposit mobilization is impaired. Worse still, when financial resources are rationed out by ad-hoc criteria rather than by profitability and implicit rates of return on projects to which they are deployed, the resulting allocation becomes inferior in terms of efficiency and

growth maximization. Failure of financial institutions to earn the highest rates of return on loanable funds on the other hand undermines their ability to pay attractive (or highest possible) rates to savers and this in turn hampers resource mobilization. The vicious cycle of excess credit demand cum declining supply of savings due to declining real interest and low return on investment from inefficient allocation prompts intensification of direct controls on credit allocation and further crowding out of the chick that lay the egg (i.e the private sector). Moreover, as real savings decline the government and the expanded public sector is forced into the printing press thereby fueling inflation which, ceteris paribus, further erodes real interest rates and savings. Further, it has been argued (see the forthcoming section) that the allocation of credit by non-commercial criteria is the major cause for non-performance of a large portion of loans in the portfolios of the financial institutions in Tanzania. This short discussion points to the important role of monetary policies on savings mobilization perfomance in Tanzania.

There is a direct link between monetary expansion, inflation, balance of payments, and exchange rate movements. From the view point of the monetary approach to the balance of payments, under fixed exchange rate regime, and starting from an equilibrium position, monetary expansion is offset by equivalent amount of foreign reserve loss. However, with exchange controls that prevent reserve deterioration by limiting imports, monetary expansion causes excess demand in the domestic goods market, and thus, inflation which results into an overvalued exchange rate. To maintain competitiveness in the export markets, and of domestic versas foreign monetary assets, the domestic currency has to be depreciated by the differential between domestic and foreign (trading partner) inflation rate. If overvaluation of the shilling is maintained for a long period, as was the case in Tanzania during 1979-88, domestic residents find holdings of foreign assets more attractive than domestic financial assets. This is much more the case when expectations are for a continued higher inflation at home than in trading partners, and reluctancy of the authorities to adjust the interest rates and the exchange rate to equilibrium. The latter three conditions guarantee windfall gains in yield at a low risk/uncertainty to holders of foreign assets. It is no wonder,

therefore, that at the time of crackdown with economic saboteurs,[1/] a large number of residents were found with huge amounts of foreign exchange, which totalled to over US$ 2 million excluding amounts held in foreign bank accounts abroad.

The impact of inflation on domestic financial savings does not only work through the exchange rate by encouranging savings in foreign financial assets, but also works through the interest rate, and rates of return on financial assets in general, especially when there are administative ceilings on interest rates. The hypothesis of financial repression, i.e. fixing nominal interest rates at levels which, given the inflation rates, produce real interest rates that are below equilibrium levels, has been analysed in great detail by various authors (McKinnon, 1973, Shaw, 1973, Fry 1978). Despite the ambigous nature of teh results obtained in empirical studies on savings responsiveness to interest rates (see, for example Arriete, 1988), there is more or less a consensus that raising real interest rates in financially repressed economies is important for at least three reasons:

(a) it would discourage domestic investment projects not yielding an adequate rate of return over the long-run;
b) ceteris paribus, high real rates of interest may raise both domestic and foreign savings and thus, total savings; and
c) realistic real interest rates would abolish rationing of loan funds, and therefore the distortions derived from financial repression, and this is expected to increase the flow of savings through the financial system, and hence the overall efficiency of the saving investment process.

The phenomenon of financial repression in Tanzania during 1967-80 has been analysed by among others, Nyagetera et al (1988), and Kimei (1986). In the analysis of the latter author, it is shown that financial repression, coupled with restrictions on entry into the financial system had disintermediation effect, evidenced by decline in the ratio of total non-monetary assets in total wealth[1/] (See Table 1).

1/ This ratio declined from about 9% in early 1960s to about 8% in 1980 (Kimei, 1986, p. 206 and 211

1/ See Tanzania, Daily News, March 28 1983.

1/ Although there was a slight rise in the ratio of monetary assets to total wealth, we are biased to believe that the extent of financial growth is more accurately measured by the ratio of non-monetary financial assets, which partly reflects growth of specialization and diversification of the financial asset menu.

Moreover, low interest rates, together with overvaluation of the shilling have been cited to be one of causes for the bias of investment towards capital and import intensive technology in Tanzania (see Wangwe, 1984), a characteristic that has contributed to industrial sector inefficiency in terms of low capacity utilisation.

One of the Central Bank functions, apart from overseeing external and domestic monetary stability, is to promote the growth of a sound financial market. This responsibility has several aspects. First, a necessary prerequisite for specialization in the financial industry is the freedom of financial institutions to design their products (i.e financial assets) in a way that differentiates a product of one financial intermediary from another by combining the attributes of yield, liquidity, risk and convenience innovatively. We have argued above that interest rate regulations do not offer that chance. Second, once a first hand market for securities is formed, financial policies have to be modelled in a way that becomes promotinal to the establishment of a secondary market, where financial assets already acquired may be actively traded to increase their liquidity. Here, the proposition that a financial asset that has to be held due to absence of a secondary market by the initial buyer up to maturity is not only illiquid but also carries high risk in terms of interest, safety and convenience. Under such circumstances, real (physical) assets may offer more liquidity and less risk than a financial asset, in which case economic units will run away from financial assets.

The Tanzanian financial experience show that the authorities have not attempted to develop the secondary market for securities. During East African Currency Board (EACB) period, however, there were strong efforts to develop the Treasury Bills market, and by 1964 the market was relatively active (see, for example EACB Report, June 1965). Infact, before the break-up, the Board had proposed to establish a two tier central banking structure and common treasury bill instrument for the whole East Africa in order to allow a greater float of securities and more activity in the market (Kimei, 1986 p.64). The total volume of Treasury bills traded in the market amounted to about East African shillings 500 million in 1984--which in 1988 exchange rates would have worked out to about Tanzanian shs. 10 billion, equivalent to some 5% of the country's GDP for 1987. However, the independent national central banks that emerged in East Africa from June 1966 and particularly the BOT, never continued the strategy of encouraging a

secondary market for government securities as an embryo of fully fledged money and capital markets.

The effects of absence of a secondary security market on the operations of the financial system especially the savings institutions that have either statutorily or by nature of liabilities been compelled to invest largely in government paper have been very damaging. The specific examples are the Post Office Savings Bank (POSB), and contractual savings institutions (the National Provident Fund, and National Insurance Company). The law establishing the POSB requires that it invests all excess deposits in government securities. Following the recent changes in the interest rate structure (prescribed by the BOT), the rates on savings deposits were raised from 10% in October 1985 to 15% from July 1986, and further to 21.5% from April 1987 and 23% and 29% from July 1987 and December 1988 respectively. During the corresponding periods, the average rate of interest on government securities moved from 8.5% in October 1985 to 13.6% in July 1986 and respectively 18.9%, 20.8% and 21.8% in April 1987, July 1987, and December 1988. The result has been a shortfall of interest earned on investment as compaired with interest paid by the POSB on deposits. Table 3 below shows the losses made by the institution as a result of the negative spread between deposit and lending rates.

Table 2: Interest earned on POSB's Investment in Government Paper as a percentage of Interest paid on Deposits

Year	Interest Investment (mln shs.)	Interest on Deposits (mln. shs.)	Interest on deposits as % of interest from investment
1975	5.4	2.9	54
1976	6.1	3.3	54
1977	7.0	3.9	56
1978	8.7	5.6	64
1979	11.6	8.1	70
1980	13.9	10.9	78
1981	17.9	12.6	70
1982	21.6	19.1	88
1983	23.5	25.8	110
1984	29.3	31.0	106
1985	40.2	42.4	105
1986	59.6	80.7	135

Source: POSB, Corporate Plan 1988-90

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As for savings in form of life policies and pension contributions to the NIC and NPF, the implicit rates of capitalization have been depressed by the relatively low rates on government securities, to the which the savings are mainly deployed. In particular, while the inflation rate has averaged slightly over 30% in the period 1980-88 (depending on the price index used), the average capitalization rate used by the NIC (and probably the NPF) has been only 8% per annum plus a bonus averaging about 1% per annum during 1970-88 (see, NIC's 20 years, 1983, p. 32-33). While this rate might have been realistic in late 1960s and early 1970s, when inflation was below 10%, it was drastically eroded by inflation from the second half of the 1970s to become substantially negative in real terms. Given this rate of return on life savings with NIC (and NPF), and an average inflation rate of 21% over the period 1970-88, a saving of shs. 100 made in 1970 is now worth shs. 16.3 only in real terms. The main cause for the drastic erosion of life savings turns out to be the prescribed low yields on government stock constituting the major form in which these savings are invested. Irrespective of the causes for the low yields, the main issue of concern should be the discouragement of savings that results from the inflation tax.

The performance of financial institutions is directly related to the quality and motivation of their staff. Properly recruited and motivated bankers work efficiently, being responsive to customer demands, and effecting mobilization and allocation of resources to projects offering maximum returns at least risk. The main motivation to employees results from their remunerations in real terms. The latter problem is primarily related to the country's high inflation record (see, Table 4), and basic to understanding its controllability. is an analysis of the sources of liquidity expansion in Tanzania.

In Tanzania, the contribution to expansion in broad money of credit to the expanded public sector--the central government and the SOEs combined--rose from an average of 64% in 1970-75 to 109% during 1981-86 (see, Table 2.2). As result, credit to the private sector recorded a declining share in the growth of the money supply averaging 21% and 7% during 1970-75, and 1981-86 respectively. Only in the period after June 1986 did the contribution of bank credit to the private sector start to pick up, reaching 25 % in June 1988. The foregoing trend suggest that the government, and the public sector at large, have been the major source of liquidity expansion and inflation in Tanzania,

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especially in the past ten years or so. Nevertheless, the inflation created by the government was not on account of increased wages, but rather on purchases on non wage goods--and sometimes the puchases of fictitious and over invoiced goods.[1/] In this connection during the 18-year period beginning 1970, the minimum wage in real terms (1977 prices) saw a decline of over 70%, from shs.400 in 1970 to shs. 115 in 1988 (see, Table 5). This should well reflect the trend of the average real wage since in Tanzania it is the administrative adjustment of the minimum wage rate that sets the tone for review of the other salary scales, in most cases with rise in minimum wage rate by far exceeding increase in the above-minimum scales.

To the extent that the public sector bank borrowing by far exceeded credit extended to the private sector, it becomes inconceivable that monetary policy could have been effective in sterilizing the implications of the fiscal stance on monetary expansion given the specific conditions in Tanzania. We may therefore conclude that the wage and incomes policy of the government has been the major factor explaining real wage deterioration in the country--and with that, the decline in motivation, work incentives, creativity and productivity in general, and erosion of banking ethics in particular.

4.1.2. WEAKNESSES PERTAINING TO FINANCIAL INSTITUTIONS--with reference to NBC

The commercial banking sector in Tanzania mainland was under the monopoly of the NBC until 1984 when the CRDB was given commercial banking privileges. Even then, up to 1988, the CRDB remained relatively small, accounting for some 7% of total bank deposits. Among the financial institutions in the country, only the NBC and the Tanzania Housing Bank (THB) engaged in deposit mobilization - with the latter accepting savings and term-deposits only. Over the period, especially in 80s the performance of the NBC in both deposit mobilization and deployment has been discouraging. Total NBC deposits

1/ This ratio declined from about 9% in early 1960s to about 8% in 1980 (Kimei, 1986, p. 206 and 211

1/ See the Tanzania, Daily News of 10 February 1989 for a story of a Cooperative Union that procured ficticious crops to the tune of shs. 1.6 bln.

in real terms declined throughout 1980-87, reversing the trend recorded in 1970s. Thus, whereas total NBC deposits in real terms rose at an average rate of 12.5% during 1971-79 they declined at an average rate of 9.4% annually during 1980-88 (see, Table 6). It is noteworthy that during the period when the degree of financial repression (expressed by the negative real deposit rates of interest) was mild (1971-79) interest earning deposits grew slower than the demand deposits (non-interest earning). On the other hand, in the period 1980-88, when financial repression intesified, both demand and interest earning deposits declined, with the latter falling at a slower pace. These trends are contrary theoretical expectations, and may suggest that interest rate policy is not the major factor explaining deposit mobilization performance of the NBC. ne has therefore, to look for institutional factors to explain the underlying trends.

The author was privileged to attend some discussions held by some members of the Presidential Commission of Enquiry into the monetary and Banking System in Tanzania with the clients and management of the financial institutions, including the NBC. The following were repeatedly echoed at all fora as the major factors discouraging the public from using the NBC as depository or as a source of loans:

a) On Handling of Deposit Accounts:

(a) Poor customer services on NBC counter coupled with time consuming queues at times of depositing and withdrawing money;

(b) Complete lack of bank secrecy with result that information about depositors accounts flows at ease to interested parties--tax authorities, anti-corruption squad, individuals etc;

(c) Deterioration of confidence in the bank as a safe custodian, given the large and increasingnumber ((and amounts) of thefts, forgeries and frauds made public through the media;

(d) In connection with (c) above, required statements of accounts are not prepared and mailed to customers, and even where the customers follow them up they are receivedafter a long time on the counter, and worse still, they turn out to be inaccurate;

(e) the collapse of confidence in the cheque and bankers draft as a payment instrument due to, among other things:

--non-acceptance of the bankers draft for encashment at sight, and long time taken to verify authenticity with issuing branch.
--increasing cases of bounced cheques due to laxity in the implementation of the Cheques Act, 1969,
--increased forgeries of cheques by collaboration between bank staff and the public;

(f) long delays in remittance of funds by Telegraphic Transfers (TTs), despite high commissions charged for the service--it was alleged that a TT between two main towns like Arusha and Dar es Salaam was sometimes taking over a month, making the whole operation meaningless.

b) On Handling of Client Borrowers:

(i) Long, bureaucratic and complicated procedures in processing loan and overdraft applications, resulting mainly from centralisation of decision making at the NBC headquarters- even in respect of amounts which at the prevailing purchasing power of the shilling appear to be quite small - cause delays (of to over half a year) in approvals and disbursements of loan facilities.

(ii) Under-financing of projects/activities resulting from delays in processing loan applications in a hyperinflationary environment (coupled with exchange rate volatility).

(iii) Little interest of bankers on borrowers projects to be financed and on the borrowers reputation in the bank, and undue emphasis on availabilty of tangiable security and / or title deeds on land as preconditions for loan approvals.

(iv) Inadequate loan follow-up to ensure proper end-use and recovery;

(v) In some instances, clients have to provide sustantial amounts in bribes for their loans to get approvals.

The foregoing list of clients complaints on the operations of the NBC is not exhaustive, as the idea here is to highlight the major ones. However, it should be noted that whereas depositors rarely complained about interest rates as a deterrent to savings, borrowers felt that the revision of the interest rate structure in the recent two years has brought them to levels that were prohibitive for small productive non-export oriented businessmen. It would appear then that whereas savers may be marginally responsive to interest rate changes, long and medium-term investors show a lot of concern about loan rates.

c) The Bank's Management Response to the Client Complaints

In response to some of the complaints given in the preceding paragraphs, the NBC management gave the following arguments

(a) The hiring, firing and motivationof staff in the financial insititutionsin general is seriouslyimpairedby the complexity and inflexibility of civil service staffingguidelines,including the direct controls by the Presidential Standing Committee of Parastatal Organizations(SCOPO),and the Security of Employment Act of 1964. The latter complicatesand almost rules out the possibility of employers to sack inefficientand/or indisciplined employees;

(b) Rapid branch expansionwith the intetion of bringingbanking services to remote areas could not be matched by equiproportionate growth in administrative/manpowercapacity (quantitavely and qualitatively) due to limited resources;

(c) Overall economic infrastructure- particularly communications - has been inefficient, with the result that interbranch communication through the Post Offices is impaired . The latter is allegedly, the cause of delays in TTs and other instrumentsused in transferring funds;

(d) Out-dated technology;

(e) More important,on the efficiency of lending operations,the NBC has had little, or no control at all, over limits of exposure to its major clients--the parastatals, marketing boards, and cooperative unions. The government and the party authoritieshave forced the Bank (by providing guaranteesor mere directives) to extend loans and overdrafts to these latter institutions,even when the bank's evaluationsindicatethat the intendeduses were nonviable. As a result, the bank's loan recovery rate has deteriorated,and up to about 70% of its loan portfolio is considered non-performing (see Coopers and Lybrand Study on NBC).

(f) The Bank's terms of lending and of deposit mobilizationare determinedby the monetary authorities,and this, other things being equal, determines its profitability.

5. OVERALL INTERPRETATION OF THE PERFORMANCE

The problems facing the Tanzanian financial system--as represented by the NBC--boil down to four fundamental issues: First, absence of competition; second, inadequate monetary policy framework; third,

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weaknesses inherent in the macroeconomic envirnment, especially, the question of capital adequacy and solvency of major borrowers; and finally, inadequacies in the regulatory framework.

5.1. Absence of Competition:

The recorded deterioration in customer services, innovation and banking ethics within the NBC, and indeed in other financial institutions as well, is principally attributable to lack of competition in the financial market. This has eloquently been put by one of the clients of the NBC, Salum Shamte who noted "The NBC has for long time had a stonghold on the common man who has no alternative, but needs banking services. Unfortunately the NBC has grown lax and forgotten completely that the depositors and borrowers are the customers. Competition will improve services to the users of the banking system".

The NBC's monopolistic position in the commercial banking business in Tanzania, as are the other specialized financial institutions, has some specific elements. First, although the NBC is required by its statute to observe commercial principles in its operations, the bank has no control over its deposit and loan rates of interest. Second, in practice, the NBC has been operating under severe political pressure, with the result that most of its branch expansion, and lending decisions have been made under the influence of politicians.

Due to absence of competition, the array of savings instruments offered by the NBC have been quite limited. The schemes in force include counter services, pay day collection scheme, payment of salaries through bank accounts, mobile agency services, estate agents scheme, deposit life assurance scheme (run jointly with NIC), school banking and minors scheme, and cumulative deposit scheme, money boxes scheme, and cumulative deposit scheme. These schemes fall short in providing additional means of payments in form of instruments with appropriate degrees of liquidity and market risk. One may, therefore, doubt that the financial system in Tanzania has been innovative enough in producing intruments that are well differentiated in terms of degrees of liquidity, yield, riskness, marketability and convenience of access - and for that matter, succesful in saving mobilization.

5.2 Inadequacy of the Monetary Policy Framework

5.2.1 The Conduct of Monetary Policy in Tanzania

The responsibility for the conduct of monetary policy in Tanzania rests with the Bank of Tanzania (BOT). The Act establishing the central bank gives it all the traditional powers and instruments for regulating monetary aggregates, including such tools as reserve and liquidity ratios, interest rate policy, open market operations, and selective credit policy. However, as the premise of competitive banking--under which the inaugural BOT Act was enacted got altered by the adoption of the Arusha Declaration of socialist policies in 1967, followed by the nationalization of banks and other key financial institutions--it became imperative that the thrust of monetary policy had to change. The desire to effect monetary policy more selectively, to redistribute resources in favour of the public sector, entailed greater reliance on direct instruments of credit control. Nevertheless, it was not until 1972 that the BOT Act was amended for the purposes of giving the central bank instruments of monetary control of a more direct nature, although the introduction of annual financial planning in 1971/72 had necessarily rendered the application of traditional monetary policy instruments redundant.

During the initial period of independent central banking, 1966-71 pressure on bank credit demand was relatively low, largely because the government maintained more or less fiscal balance--as its investment remained limited by low project implementing capacity. Under these circumstances, moral suasion was the main approach to attainment of monetary stability. However, in early 1970s, the demand for financial resources was projected to be much higher than could be afforded by non-inflationary monetary expansion. In a bid to ration the limited resources in favour of the public sector, the Annual Finance and Credit Plan, and the Foreign Exchange Plan were introduced in 1971/72, as major instruments of monetary policy, aided by secondary instruments like interest rates, variable reserve, and liquidity requirements. However, over the period 1972-82 the latter types of tools were rarely used. For example, over the 10-year period, 1970-80, the interest rate structure was adjusted only twice; while reserve and liquidity requirements remained constant. Only in the recent period, 1985-88, has interest rate policy been relatively active--with changes in the structure taking place 2-3 times a year (see, Table 7).

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The key variables of the Finance and Credit Plans have been domestic credit formation, comprising bank lending to government and non-government sectors, money supply targets, and net foreign assets. The latter is projected in the Foreign Exchange Plan.

The essence of financial planning is to ensure that the savings mobilized by the financial system are made available to the various economic activities according to "socio-economic priorities" of the government, without disturbing domestic and external monetary stability. Thus, the Annual Finance and Credit Plan provides the targets for credit to government, credit to various sectors other than government, and growth in money supply. The starting point of this excercise is the determination of the permissible rate of monetary expansion on basis of anticipated real income growth and assumptions regarding inflation. Within the parameters of non-inflationary monetary growth, and the net foreign assets it is then possible to determine the dimensions of credit formation in the economy. Bank credit to government is normally derived from the budget estimates, so that the rest of the economy gets the residual. However, within the latter group of sectors, credit is distributed between specified crop marketing authorities (Marketing Boards and Cooperative Unions) and the rest of non-government sectors. Usually, due to slow stock turnover, the crop marketing authorities tend to account for over 50% of total credit expansion. Credit requirements for the crop marketing authorities are estimated on basis of expected production, producer prices, administrative, handling and processing costs of the crop Boards, expected quantum of sales (export and local), and expected export and local selling prices.

The attainment of the Finance and Credit Plan targets has been made difficult by, among other factors (see Kimei, 1986 Ch.5):

a) excessive (over and above desired) credit demand arising from stock build-up, and trading losses particularly by crop marketing institutions. The former results mainly from transportation and processing bottlenecks, while the latter arise from a combination of factors, including pricing policies, behaviour of international commodity prices and management efficiency;

b) difficulty in resisting political pressure on banks to extend credit to particular parastatals irrespective of their creditworthiness--with a result that a substantial chunk of bank credit is non-performing, thereby weakening the liquidity position of the banks.

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c) the problem of controlling government borrowing from the banking system.

As mentioned earlier, the BOT has not actively followed up the implementation of the Finance and Credit Plan by backing it up with supportive monetary policy instruments at its disposal (eg. interest rate policy etc.). On the contrary, the central bank itself has in most cases yielded to political pressure by accepting to accomodate what are perceived as 'special credit needs' even after the drawing up of the financial plan. The latter has exercebated the overshooting of planned monetary aggregates--a process that has fuelled inflation in Tanzania (see Table 4 for Tanzania's inflationary trends).

Apart from the pre-emption of monetary policy instruments by financial planning, the use of traditional monetary policy instruments in Tanzania is further impaired by the following major characteristics of the financial market, and the economy in general.

i) Low degree of monetization , with the result that monetary controls may leave a substantial part of the economy unaffected (see Pendharkar and Narasimham, 1966). The national accounts of Tanzania have not attempted to estimate separately the contribution of subsistence production to the GDP in the past 5 years or so. However, the share of subsitence production took an upward trend following the entry of the economy into high inflation episodes from the mid 1970s. In this connection, during 1974-81 the value of subsistence production in real terms (1966 prices) rose at an average rate of about 5% while GDP rose at an average rate of about 4% (see Kimei ,1986 p.48). Evidence suggest that over the period 1981-1988 the share of the subsistence sector continued to increase. In this regard, primary production (into which most subsistence activities fall) has increased its share in GDP substatially,from 45% in 1980 to 61% in 1988. Assuming that the share of subsistence production in GDP has been roughly equal to 50% of that of primary production (as it was in mid-70s), then that share may be estimated to have risen from about 23% in 1980 to 31% in 1988.

ii) The increase in informal financial sector operations

The term "informal financial sector"--also reffered to as "unorganized financial sector" or "non-institutional financial sector"--covers all financial activities outside the ambit of

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institutional finance (see Keith Hart 1973) . The most important characteristics of this sector include (see Chandavarkar, 1988):

(a) proprietary or mutual ownership, eg. 'Upato' Schemes in Tanzania;
(b) complete freedom of entry and exit , which makes the market more or less perfectly competitive ;
(c) low costs of transactions and information gathering due to informality of transactions and intimate knowledge of customers on part of lenders,
(d) freedom from central banking controls, such as cash reserve and liquidity ratios, interest rate and portfolio ceilings, selective controls etc;
(e) higher effective rates of interest than in institutional financial sector,
(f) evasion of implicit taxation of institutional sector through pre-emption of government funds at repressed rates of interest and subsidized borrowing by some institutional sectors; and
(g) much less controlled end-use of credit, and less discrimination of credit for consumption purposes.

The informal financial sector partly reflects the activities of the so-called "parallel economy" which is essentially a mechaism of evading taxes and other financial controls including credit and foreign exchange regulations (see Vito Tanzi, 1983). Strictly speaking, the formal financial sectors are not independent . In most cases, the non- institutional lenders borrow from the formal money markets for relending to the informal sector spills over into the former. As a result, credit policy (squeeze or relaxation of lending requirements on banks) would have some impact on the availability of credit in the informal sector for meeting their excess credit needs or deployment of excess funds, the informal financial sector may be seen as a cause of financial disintermeditation. The latter erodes the effectiveness of monetary policy and causes fragmentation of money and capital markets--something which also hampers efficient mobilization and deployment of savings.

In Tanzania, the parallel market has taken strong roots beginning early 1980s when commodity and foreign exchange scarcities became acute. Further, given that the minimum subsistence wage in Dar es salaam is currently estimated at over shs. 6,000 per month (based on the Household Budget Survey, 1976/77 and current market prices), while the official actual rate is about shs. 1,500 per month, one may assume that the gap (about 75%) is largely met through informal activities. Moreover, as pointed out earlier credit rationing infavour of the

public sector through annual finance and credit plans from 1971 onwards has severely constrained credit availability to the private sector especially for non-directly productive sectors and consumption. It is, therefore, quite plausible that informal financial arrangements have grown rapidly in the past 10 years.

No attempt has been made to estimate the size and activity of the informal sector in general, and the informal financial sector in particular, in Tanzania. However, the available ad-hoc evidence that the size and scope of that sector is sizeable. According to a study by Bagachwa (1982), of 71 informal establishments surveyed, only one admitted to have obtained a meagre loan of shs. 15,000 from formal financial institutions (the NBC). Thirty establishments (42%) admitted to have obtained loans from relatives and friends, while 37% of establishments confirmed to have obtained credit from other informal trade dealers.

iii) Volatility of the Money Multiplier:

Since the liabilities of the non-institutional financial sector do not posses the attributes of money, and currency is the predominant transactions medium, informal sector credit operations do not create a significant flow of deposits -- remember that in banking practices credit formation is counter --matched with deposit creation. As a result the money multiplier in an economy with a growing informal financial sector tends to be dampened (Chaudavarkar, 1988 p. 85). The behaviour of the money multiplier in Tanzania over the period 1970-88 is presented in Table 8 (see, also Chart 1). In line with the foreign argument, the money multiplier which had remained slightly above 3 in the 1970s, started a downward trend from 1980, reaching as low as about 2.3 in 1987.

The money multiplier volatility renders the control of the money supply through the monetary base unachievable. In this connection, reserve requirements--which are a major means of controlling base money--turn out to be an ineffective monetary policy instrument.

iv) Unpredictability of the demand for money as measured by the velocity of money circulation:

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Over the past two decades, the demand for money in Tanzania has been extremely unstable - especially when proxied by income velocity of narrow money (see Table 9 and Chart 2). This behaviour cannot be a surprise in an environment that has been characterized with severe economic shocks, both of external and domestic origin. The implication of the behaviour, however, is that the monetary authorities cannot exert effective control over the monetary aggregates and hence inflation.

v) Absense of an active secondary market for securities

Among the most popular tools of monetary policy is open market operations through which liquidity can be contracted or injected into an economy by a central bank selling or buying of marketable securities. The evolution of a securities market may follow demand, provided that market interferences are minimal- so that supply and demand are the major determinants of the rates of return (or interest rates) in the market. In a regurated economy as in the Tanzanian case the promotion of a securities market should be taken as a deliberate policy action if such a market is to grow at all.

vi) Non-profit maximizing nature of financial institutions:

For the traditional monetary policy instruments to become effective the banks and other financial intermediaries constituting the subjects of monetary controls have to be profit maximizers (or cost minimizers). If the institutions are indifferent to profit and costs, the instruments will be rendered redundant. An example, drawn from Tanzania's experience, may illustrate this. During the late 1970s and early 1980s the commercial banks, and indeed, other financial institutions in Tanzania, were awash of funds (see Nyirabu, 1980 p. 4-5). An imposition of reserve requirements with a view to reduce lending capacity and hence monetary formation under such circumstances may be ineffective. Moreover, an increase in central discount rate, with the view to compress aggragate demand might -- under non-profit maximizing banks--not trigger the expected general rise in interest rates, and for that matter may be pre- empted as a monetary contrationary measure . Thus, for example in Tanzania, the Sharp increase in the bank discount rate from about 13% in 1987 to 22% in 1988 (a level almost at par with the prevailing interest rate on savings deposits) did not induce a reduction in commercial bank's

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recourse to the Bank of Tanzania. On the contrary, commercial bank borrowing from the central bank continued with an upward trend, registering an annual rise of over 250% in the year ended June 1988 (see BOT, operations Report, June 1988).

5.3 Weaknesses inherent in the Macroeconomic Environment:

The macroeconomic environment in the Tanzania has most likely been responsible for an inefficient financial system. The administrative regulations on the markets for goods, labour, capital and land , that were intensified following the Arusha Declaration of socialist orientation of 1967 have implied severe distortions of market signals. Over the period 1967-85, the following major regulations were introduced on the respective markets:

5.3.1 Regulations on the Goods Market:

Price controls were introduced in 1967, but got institutionalized with the formation of the National Price Commission in 1973. Agricultural producer prices have been under direct government control since 1967. Commodity confinement policy, under which trade in all major capital and consumer goods, as well as intermediate inputs was confined to specialized National and Regional Trading Companies was introduced in 1972 and strengthened from 1979/80. Import licencing was introduced in 1971, first with an open general licence (OGL) list of goods that were automatically licenced, and later from 1981 without the OGL when foreign exchange scarcity worsened. 1/

Generally speaking the controls on the goods market have in one way or another affected the financial perfomance of the non-financial institutions that constitute the clients of financial intermediaries.

5.3.2 Regulations on the labour market

The labour market has been controlled in four main ways - by imposing minimum wage/salary regulations, ensuring full control over the workers' union (JUWATA) to rule out effective wage bargaining process;

1/ This ratio declined from about 9% in early 1960s to about 8% in 1980 (Kimei, 1986, p. 206 and 211

1/ The OGL system was reintroduced with strong backing of the World Bank in 1988.

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direct government regulation of genaral terms of employment in the parastatal sector via the Standing Committee on Parastatal Organizations (SCOPO).

The result of these regulations--which also hold for financial institutions-- has been to deprieve employers of their creativity in ways and means for employee motivation for increased productivity . This has been reinforced by the fact the regulations apply more or less uniformly across sectors, without due regard being paid to industry specificities.

5.3.3. Financial market regulation:

In the previous sections, mention has been made of various financial regulations such as nominal interest rate ceilings and credit rationing by the mechanism of the Finance and Credit Planning. The other crucial regulation that has to be added is the restriction of entry and exit of institution into the financial arena, which is rooted in the Acts of establishment of the NBC and other financial institutions. The latter has had negative implications on competition, and hence innovation and efficiency.

5.3.4. Other environmental weaknesses:

One of the most important characteristics and weaknesses of the Tanzania's financial sector as a whole is the pressure impossed by a high degree of non-performing loans.The explanation given by the management of the NBC for poor loan recovery rates are:

(i) Inadequate capital structure of the major borrowers --the parastatals and cooperative unions--which have been compelled to divert short term (crop finance etc) credits to financing of fixed assets, as they were given little (if any) capital at a time of establishment .This is the other side of the proposition advanced earlier , that the government overstretched its resources by attempting to have command over everything (even over what does not appear to be commanding heights like butcheries and football associations). This overstretching has not only contributed to inflationary financing of the budget, but also to the capital inadequacy of

institution established by the government (state owned enterprises).

(ii) Controlled pricing of some commodities--particularly food grains - has entailed substantial amount of subsidies to the parastatals handling the goods. The governments failure to disburse the subsidies timely (due to budgetary pressure) has deterred the respective parastatals from retiring bank credit extended to them year after year. A good example of this is the National Milling Corporation (NMC) , of which overdue credit outstanding on its account as of end June 1988 accounted for about 20% of total bank credit to non-government sectors by the NBC.

(iii) Unrealistic exchange rate management:
An overvaluation of the shilling exchange rate, coupled with administrative fixing of producer prices, and autonomously determined processing and handling costs for Tanzania's major exports, led to a situationwhereby a large number of the export parastatals became substantial loss makers. The major contributory element into the losses was unrealistic pricing of foreign exchange earnings during 1978-88. The basic question that arises is the way in which the losses made by the marketing parastatals (and infact, other parastatals as well) were passed to the banks. Should the banks and other financial institutions be blamed for poor risk management - extending credit to finance losses ? The answer is yes and no. It is yes, because the financial institutions are required by their respective status to operate on commercial principles - which means, among many other things, evaluation of loan applications by traditionally acceptable banking methods and rejection of unprofitable risks irrespective of the nature of clients. It is no, because the major owner of the financial institutions--the Treasury--issued guarantees for credit extended by the financial institutions to the parastatals, over and above the amounts which the banks were ready to extend on their own evaluations. In this way the banks were indirectly made to accomodate the parastatals sector losses. as of June 1988,of the total outstanding credit to marketing parastatals of shs.24,017 million, 56% or shs. 13,643 million was considered un-recoverable or having been used to finance

losses. This amount was mainly on account of the grain marketing parastatal (the National Milling Corporation), the Tanzania Cotton Marketing Board, and the Tobacco Processing and Marketing Board.

6. Concluding Observations

The foregoing analysis suggests, among many other things, that basic to an effective deregulation/reform of the financial system with a view to improve its efficiency in Tanzania, and probably elsewhere, is an overall economic reform that will create a viable environment for non-financial economic entities, constituting the clientiele of the financial system. As a pre-requisite for this condition, deregulation of the non-financial markets becomes crucial for successful financial reform. Moreover, for financial deepening to take place, monetary stability--and hence anti-inflation tax policies--have to be pursued. For the latter to be achievable, or realistic, the authorities must strive to evolve a monetary policy framework under which various policy instruments will become effective for reducing or increasing domestic liquidity. It is therefore arguable that there is a two-way causality between the financial system and monetary policy. On one hand, it is the type of the financial structure that determines the effectiveness of monetary policy instruments. On the other side of the coin, monetary policy plays an important role in financial development.

Table 1: [illegible]—Financial Survey, 1980–91

ITEMS	1980	1981	1982	1983	1984	1985	1986	1987
A: ASSETS								
1. Foreign Assets (net)	1201.1	888.2	763.5	1001.9	-7000.2	-10700.0	-12000.0	-19987.4
Monetary Survey (net)	1199.6	883.7	761.7	1079.9	-7002.5	-10700.3	-12000.7	-19988.7
Non-monetary Fin. Inst.(net)--IPFI	1.5	1.5	1.8	2.0	2.3	2.5	2.6	3.3
2. Domestic Credit (net)	28762.5	25400.7	31006.6	34405.4	40999.9	55000.1	64000.0	92131.2
2.1 Claims on Govt. (net)	11061.0	14018.2	18090.9	21094.7	25000.1	33000.0	34402.9	34001.2
Monetary survey (net)	10099.0	13024.4	17037.1	20008.1	24400.0	32270.9	32000.0	33464.5
Non Monetary Fin. Inst. (net)	962.0	993.8	1052.8	1295.6	1370.1	1630.0	1007.1	946.7
2.2 Claims on Non-Govt. & Private	9100.7	10320.5	12404.6	13300.7	15161.0	20047.2	30000.1	57000.0
Monetary Survey (net)	7540.4	8402.3	9607.3	10642.0	12922.2	17670.0	27700.1	55042.5
Non-monetary Fin. Inst. (net)	1704.3	2130.2	2919.3	1008.9	2239.6	2360.4	2001.0	2707.5
TOTAL ASSETS	21968.6	26200.9	31800.0	36015.3	38400.7	45100.3	51900.1	72190.0
B: LIABILITIES	21968.6	26200.9	31800.0	36015.3	38400.7	45100.3	51900.1	72190.0
1. Monetary Liabilities	13112.9	16110.2	17006.0	20207.0	20124.7	24002.5	30106.0	40021.0
Money (M1)	13045.9	15401.2	16523.2	20064.3	20037.1	23270.2	30000.5	47130.6
Less: Reserves (IPFI)	255.0	291.0	306.4	357.6	412.4	407.7	623.6	900.0
2. Quasi-Monetary Liabilities	4000.7	6097.2	7263.9	9006.6	10076.4	13070.6	16015.4	21200.0
Quasi-money (M2)	4173.9	5293.5	6400.5	8543.1	9001.0	13700.0	14040.9	19012.5
Sub-Total (Broad Money)--M2	17519.0	20694.7	24720.7	29127.4	30210.1	30971.0	30065.4	66402.9
Time, Savings, F/currency deposits (IPFI)	724.0	903.7	808.4	1042.5	1190.4	1377.0	1771.5	1923.5
Sub-Total (Broad Money)--M3	18011.6	21207.4	25200.7	29012.6	31001.1	30041.1	31001.4	68007.6
3. Long-term Foreign Liabilities	200.7	423.0	462.9	900.0	832.3	794.1	1534.6	1000.7
IPFI	200.7	423.0	462.9	300.0	832.3	794.1	1534.6	1000.7
4. Government Lending Funds	111.2	109.0	113.0	90.0	119.3	60.0	67.2	64.5
IPFI	111.2	109.0	113.0	90.0	119.3	60.0	67.2	64.5
5. Insurance Reserve Funds	905.6	1221.2	1670.6	2100.2	2751.9	3204.0	4154.9	5200.0
6. Other Items (net)	2646.6	2020.3	4002.6	3000.9	-1274.9	-919.0	-6206.0	-2001.0
Monetary Survey	1925.2	2366.7	3107.4	4054.4	-421.4	197.4	-2040.2	2113.4
IPFI	741.3	709.6	1224.6	-200.5	-040.5	-1116.9	-2546.0	-0040.2
Memorandum Items								
GDP at market prices	37404.0	40000.0	52340.0	62000.0	70140.0	100000.0	140000.0	190100.0
As Ratios of GDP								
Total liquid assets/liabilities	58.6	59.9	60.6	58.0	42.0	38.9	38.3	38.4
of which								
Monetary Assets/Liabilities (M3)	48.1	48.3	48.1	47.6	39.7	37.0	36.0	34.4
Broad Money (M2)	46.8	47.1	47.1	46.5	38.7	36.1	35.2	33.5
Non-monetary fin. liabilities	10.6	11.6	12.3	10.4	3.1	3.0	0.3	2.1

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Table 2.1 Tanzania: Important Monetary Indicators, 1970-88

ITEMS	1970	1973	1976	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
I. GDP (current market prices)	9173.0	11490.0	21652.0	32317.0	37454.0	43906.0	52546.0	62608.0	78143.0	108083.0	143034.0	198101.0	257531.0
II. Money Supply, Broad (M2)	2305.7	3698.6	6946.7	13806.6	17519.8	20694.8	24728.7	29127.4	30218.1	38971.0	50353.4	66442.9	89809.1
o/w 1. Narrow Money (M1)	1765.5	2820.3	5331.8	10435.4	13345.9	15401.2	18323.2	20564.3	20537.1	25270.2	35809.5	47130.6	65400.9
1.1 Currency in circulation	818.4	1198.6	2071.3	4055.4	5245.4	6616.0	7988.7	8194.2	10472.4	12719.0	18309.7	24550.8	31702.2
1.2 Demand Deposits	947.1	1621.7	3260.5	6380.0	8100.5	8785.2	10334.5	12370.1	10064.7	12551.2	17499.8	22579.8	33698.7
2. Quasi-Money	540.2	878.3	1614.9	3371.2	4173.9	5293.6	6405.5	8563.1	9681.0	13700.8	14543.9	19312.3	24408.2
2.1. Time Deposits	338.1	547.0	1048.2	2308.0	2872.7	3702.1	4533.5	6183.7	6811.0	9815.7	9632.7	12704.8	14504.7
2.2. Saving Deposits	202.1	331.3	566.7	1063.2	1301.2	1591.5	1872.0	2379.4	2870.0	3885.1	4911.2	6607.5	9903.5
III. Total Commercial Bank Deposits	1487.3	2500.0	4875.4	9751.2	12274.4	14078.8	16740.0	20933.2	19745.7	26252.0	32043.7	41892.1	58106.9
IV. Reserve/Base Money	821.1	1213.4	2088.4	4128.5	5289.0	6807.2	8217.7	8480.0	10902.0	13499.2	18403.1	26250.5	34062.3
o/w 1. Currency outside banks	818.4	1198.6	2071.3	4055.4	5245.4	6616.0	7988.7	8194.2	10472.4	12719.0	18309.7	24550.8	31702.2
2. Commercial bank deposits with central bank	2.7	14.8	17.1	73.1	43.6	191.2	229.0	285.8	429.6	780.2	93.4	1699.7	2360.1
Memorandum Items:													
As a % of GDP													
1. Money Supply, Broad (M2)	25.1	32.2	32.1	42.7	46.8	47.1	47.1	46.5	38.7	36.1	35.2	33.5	34.9
2. Narrow Money (M1)	19.2	24.5	24.6	32.3	35.6	35.1	34.9	32.8	26.3	23.4	25.0	23.8	25.4
3. Currency in circulation	8.9	10.4	9.6	12.5	14.0	15.1	15.2	13.1	13.4	11.8	12.8	12.4	12.3
4. Total Commercial Bank Deposits	16.2	21.8	22.5	30.2	32.8	32.1	31.9	33.4	25.3	24.3	22.4	21.1	22.6
As % of Narrow Money:													
1. Currency outside banks	46.4	42.5	38.8	38.9	39.3	43.0	43.6	39.8	51.0	50.3	51.1	52.1	48.5

[illegible]

End of Period	Consumer Price Index (1977=1)	Demand Deposits 80	Savings Deposits 30	Time Deposits, TD	Total Savings (30 + TD)	Total Deposits 80 + 30 + TDC	Growth rate (30 + TD)	Growth Rate Total Dep.	Nominal Interest (1-yr Savings)	Interest Real (1-yr savings)
1967	0.379	622.3	128.4	128.7	249.1	871.4			3.5	
1968	0.388	582.8	140.8	257.9	398.9	980.7	48.5	4.4	3.5	1.9
1969	0.400	638.2	159.2	314.4	473.6	1108.6	32.7	21.3	3.5	-3.0
1970	0.424	608.1	182.5	298.6	478.1	1186.2	-0.1	4.7	3.5	0.1
1971	0.441	1093.7	199.4	379.1	578.5	1672.2	22.3	44.6	3.5	-0.5
1972	0.479	1107.0	239.0	466.0	705.0	1812.0	21.9	8.4	3.5	-6.1
1973	0.528	1336.6	305.0	584.0	887.0	2143.0	14.5	18.3	4.0	-6.2
1974	0.632	1794.0	362.0	558.0	920.0	2714.0	14.0	26.6	4.0	-15.7
1975	0.796	2573.0	453.0	640.0	1073.0	3646.0	16.6	34.4	4.0	-21.9
1976	0.861	3306.0	525.0	852.0	1376.0	4681.0	28.1	28.3	4.0	-2.9
1977	0.900	3762.1	646.9	1255.1	1899.0	5661.1	38.1	20.9	4.0	-7.6
1978	1.046	4176.5	788.9	1464.7	2213.6	6390.1	16.6	12.9	5.0	-7.2
1979	1.284	4642.0	990.5	2029.6	2968.1	9402.9	33.7	48.9	5.0	-7.9
1980	1.567	5306.0	1175.4	2503.6	3677.0	9046.0	24.2	0.4	5.0	-25.1
1981	1.960	5609.7	1409.5	3051.4	4460.9	10190.6	22.1	12.7	6.0	-19.7
1982	2.539	7032.2	1746.5	4870.9	6617.4	13649.6	29.5	26.1	7.5	-21.4
1983	3.226	7900.2	2213.1	5339.2	7552.3	15461.5	29.0	20.3	7.5	-19.6
1984	4.392	9408.9	2584.5	6279.9	8864.4	18008.3	17.4	19.7	7.5	-28.6
1985	5.854	11140.0	3006.8	7212.9	10219.7	21360.3	15.3	19.5	10.0	-25.3
1986	7.752	12906.4	4124.1	9051.1	13175.2	25700.6	28.9	20.6	10.0	-17.4
1987	10.074	15705.1	5210.4	9280.2	14490.6	30100.7	9.8	17.1	24.0	-6.0
1988	13.197	21776.3	7520.4	10444.7	17965.1	39641.4	22.9	31.1	29.0	-2.0
Real Magnitudes										
1967	0.369	1642.0	338.8	318.5	657.3	2299.2			3.5	
1968	0.386	1488.6	387.8	548.6	927.0	2542.9	41.0	2.8	3.5	-0.0
1969	0.410	1557.1	388.3	766.8	1155.1	2692.2	24.6	13.9	3.5	-3.0
1970	0.424	1611.1	430.4	705.4	1135.8	2726.9	-3.4	1.3	3.5	0.1
1971	0.441	2480.0	452.2	859.6	1311.8	3791.8	17.6	39.1	3.5	-0.5
1972	0.479	2311.1	499.0	972.9	1471.8	3782.9	12.2	-0.2	3.5	-5.1
1973	0.528	2530.3	578.9	1104.5	1683.4	4060.7	3.8	7.3	4.0	-6.2
1974	0.632	2838.6	572.8	882.9	1455.7	4294.3	-4.0	5.8	4.0	-15.7
1975	0.796	3234.9	544.0	804.0	1348.0	4582.9	-7.4	6.7	4.0	-21.9
1976	0.861	3840.0	614.6	1591.2	1615.7	5688.6	19.9	28.0	4.0	-2.9
1977	0.900	3968.1	677.8	1321.2	1998.9	5969.1	23.7	8.3	4.0	-7.6
1978	1.046	3917.9	711.9	1364.6	2076.5	5994.5	3.9	0.6	5.0	-7.2
1979	1.284	3616.9	772.0	1580.7	2312.6	7477.5	16.4	24.7	5.0	-7.9
1980	1.567	3424.4	748.8	1597.7	2346.5	5770.9	-4.6	-22.8	5.0	-25.1
1981	1.960	2864.7	731.1	1549.7	2280.8	5175.5	-2.8	-10.3	6.0	-19.7
1982	2.539	2769.7	687.9	1918.3	2291.2	5368.9	0.5	-2.2	7.5	-21.4
1983	3.226	2451.7	686.0	1655.1	2341.1	4792.0	2.2	-5.3	7.5	-19.6
1984	4.392	2144.0	588.5	1429.0	2018.5	4212.5	-13.8	-12.1	7.5	-28.6
1985	5.854	1904.0	513.6	1232.1	1745.8	3648.7	-13.5	-13.4	10.0	-25.3
1986	7.752	1623.5	532.0	1167.6	1699.6	3323.1	-2.6	-8.9	15.0	-17.4
1987	10.074	1559.0	517.2	918.2	1435.4	2994.4	-15.5	-9.9	24.0	-6.0
1988	13.197	1650.1	570.7	791.4	1362.2	3006.3	-6.2	0.1	29.0	-2.0

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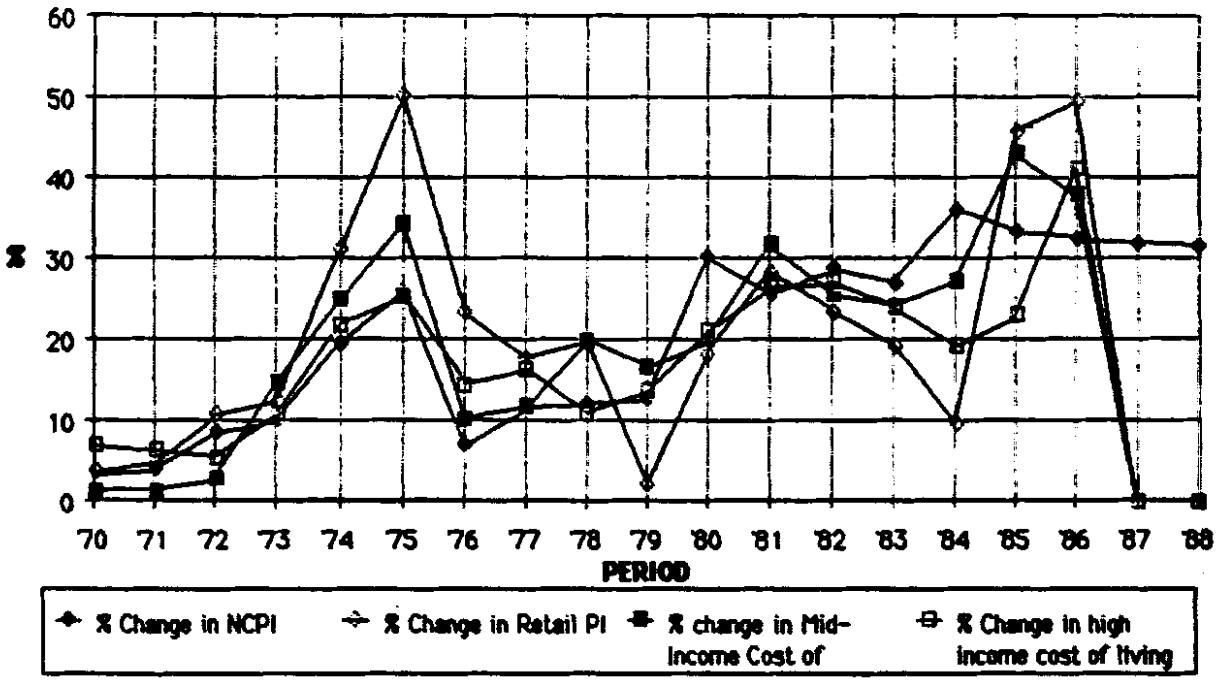
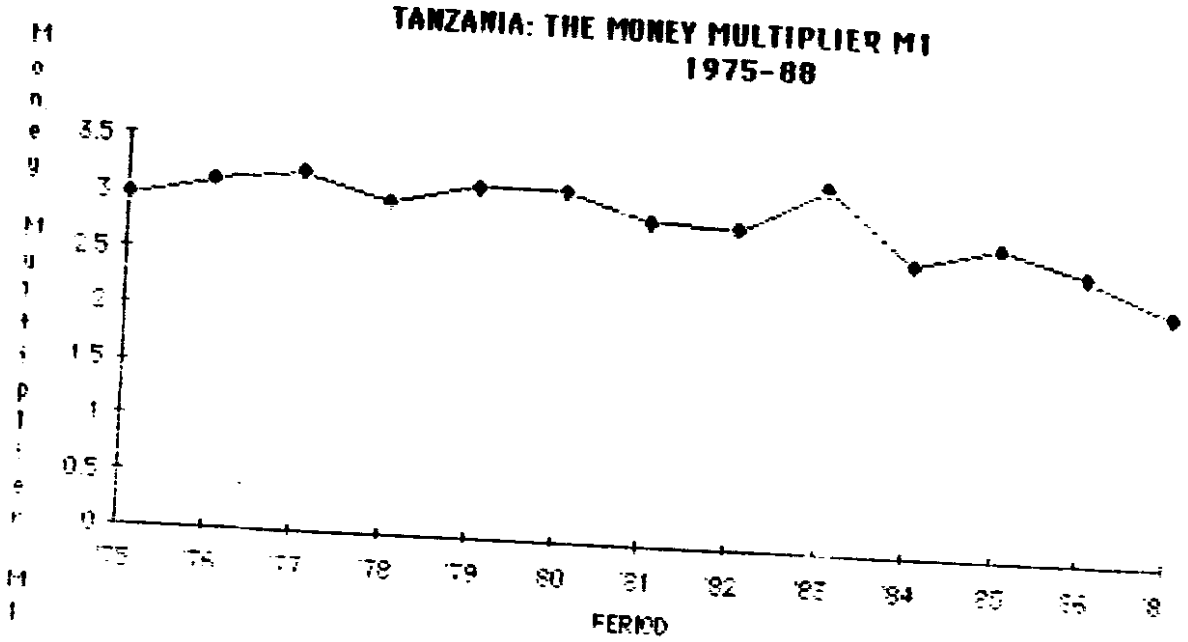
SOURCES OF MONEY SUPPLY IN % (Years ended June)

MONETARY SURVEY 29-Mar-89 6:56 PM	'1970	'1975	'1981	'1982	'1983	'1984	'1985	'1986	'1987	'1988
FOREIGN ASSETS(NET)	33.1	17.1	4.1	3.1	6.5	-25.1	-27.7	-25.6	-34.5	-28.3
NET DOMESTIC ASSETS	66.9	82.9	95.9	96.9	93.5	125.1	127.7	125.6	134.5	128.3
DOMESTIC CREDIT	70.5	99.0	108.3	109.5	107.5	123.7	128.2	119.7	133.2	122.2
Claims on Govt (net)	12.2	39.3	67.3	70.9	70.9	80.9	82.8	64.7	50.4	43.5
Claims on SOEs & Private	58.3	59.7	41.0	38.6	36.5	42.8	45.4	55.1	82.8	78.7
of which										
Major Parastatals (incl Coops)	29.5	46.9	34.8	31.4	29.8	39.7	41.6	39.2	70.2	53.8
Other	28.8	12.8	6.2	7.1	6.7	3.0	3.8	15.9	12.7	24.9
OTHER ITEMS(NET)	-3.6	-16.1	-12.4	-12.6	-13.9	1.4	-0.5	5.9	1.3	6.0
MONEY & QUASI-MONEY	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Money	76.6	77.4	74.4	74.1	70.6	68.0	64.8	71.1	70.9	72.7
Currency outside banks	35.5	31.3	32.0	32.3	28.1	34.7	32.6	36.4	37.0	35.4
Demand deposits	41.1	46.1	42.5	41.8	42.5	33.3	32.2	34.8	34.0	37.3
Quasi-money	23.4	22.6	25.6	25.9	29.4	32.0	35.2	28.9	29.1	27.3
Time deposits	14.7	14.1	17.9	18.3	21.2	22.5	25.2	19.1	19.1	16.2
Saving deposits	8.8	8.5	7.7	7.6	8.2	9.5	10.0	9.8	9.9	11.1

INFLATION TRENDS
CHART No.4



Period	% Change in NCPI	% Change in Retail PI	% change in Mid-Income Cost of living	% Change in high income Cost of living
'70	3.4	3.7	1.4	7.0
'71	4.0	4.8	1.4	6.3
'72	8.6	10.8	3.0	5.5
'73	10.2	12.5	14.7	10.9
'74	19.7	31.1	25.0	22.0
'75	25.9	50.1	34.4	25.5
'76	6.9	23.5	10.4	14.6
'77	11.6	17.8	11.8	16.5
'78	12.2	19.8	20.0	11.0
'79	12.9	2.2	16.6	13.7
'80	30.1	18.4	20.1	21.2
'81	25.7	28.4	31.8	26.6
'82	28.9	23.6	25.7	27.2
'83	27.1	19.4	24.3	24.0
'84	36.1	9.5	27.2	19.3
'85	33.3	45.8	43.0	23.1
'86	32.4	49.4	37.8	41.3
'87	32.0			
'88	31.5			



TANZANIA : TRENDS IN INCOME VELOCITY OF MONEY(M2)

CHART 2

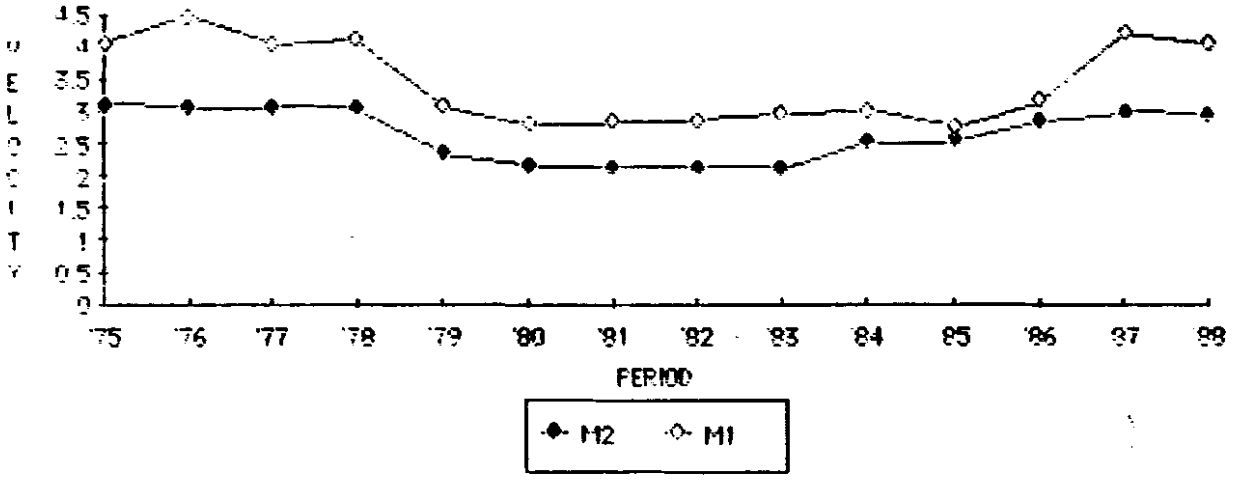


Table 5.

REAL MINIMUM WAGE RATE AND ITS GROWTH IN TANZANIA

(Selected years)

	1970	1975	1980	1985	1988
National Consumer Price Index (1977 = 1.00)	0.424	0.796	1.567	5.854	13.548
Nominal Minimum Wage p.m (in shs.)	170	380	480	800	1.560
Reel Minimum Wage (1977 prices)	400.0	477.4	306.3	136.7	115.1

Source: 1. ILO "Basic Needs in Danger", Addis Ababa, 1982 p. 266
2. Budget Speech 1987/88.

Table 6

TANZANIA: THE MONEY MULTIPLIER 1975-88

PERIOD END	CURRENCY IN CIRCULATION	COMMERCIAL BANK DEPOSITS WITH BOT	BASE MONEY	M2 (NARROW MONEY)	MONEY MULTIPLIER M1
1975	1862.9	15.8	5552.7	1878	2.96
1976	2214.9	14.7	6946.8	2229.6	3.12
1977	2565	38.3	8346	2603.3	3.21
1978	3143.5	12.4	9396.3	3155.9	2.98
1979	4278.2	109.9	13806.6	4388.1	3.15
1980	5522.9	39.3	17519.9	5562.2	3.15
1981	6950	186.8	20694.7	7136.8	2.9
1982	8381.9	244.8	24728.6	8626.7	2.87
1983	8717.3	176.4	29078.3	8893.7	3.27
1984	11341.2	230.1	30218.1	11571.3	2.61
1985	13556.6	473.4	38971	14030	2.78
1986	19451.6	269.5	50353.4	19721.1	2.55
1987	26329	1554	62777.9	27883	2.25

SOURCE: BOT, Economic and Operations Report June 1988

TANZANIA:TRENDS IN INCOME VELOCITY OF MONEY

PERIOD	GDP AT CURREN PRICE	BROAD MONEY (M2)	NARROW MONEY M1	M2	VELOCITY M1
1975		5,552.70	4,346.40	3.21	4.06
1976	21,652.00	6,946.80	5,331.80	3.04	4.48
1977	25,698.00	8,346.70	6,382.80	3.08	4.03
1978	28,582.00	9,396.30	6,827.00	3.04	4.12
1979	32,317.00	13,806.60	10,435.40	2.34	3.10
1980	37,454.00	17,519.90	13,345.90	2.14	2.81
1981	43,906.00	20,694.70	15,401.20	2.12	2.85
1982	52,546.00	24,728.60	18,323.20	2.12	2.87
1983	61,008.00	29,078.30	20,537.10	2.10	2.97
1984	76,264.00	30,218.10	25,270.20	2.52	3.02
1985	99,330.00	38,971.00	35,809.50	2.55	2.77
1986	143,034.00	50,353.40	45,091.50	2.84	3.17
1987	198,101.00	66,442.90	47,130.60	2.98	4.20
1988	263500*	89,809.00	65,400.90	2.93	4.03

*Provisional

FINANCIAL CRISES AND THE PROCESS OF ADJUSTMENT IN THE FRANC ZONE: The Experience of the West African Monetary Union

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The West African Monetary Union (Union Monétaire Ouest Africaine - U.M.O.A.), together with the member countries of the Central Bank of the Central African States, comprises the African component of the Franc Zone. The U.M.O.A. currently consists of most of the nations in the region formerly known as French West Africa: Benin, Burkina Fasso, Ivory Coast, Niger, Togo, Senegal, and Mali, which has the unusual distinction of having left the Union in 1962 and rejoined it in 1984, after a transition period of sixteen years during which France was closely involved in the management of its issuing institution.[1]

Since the second oil crisis, all of the member countries of the Union have been faced with considerable disequilibria in their balances of payments. Because of their size, these deficits have surprised most observers for whom the Franc Zone had, until recently, embodied an ideal of economic development based on major macroeconomic equilibria. The aim of this article is to describe both the process whereby such deficits came into being and the steps taken to correct them.

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* The author is grateful to Sylviane GUILLAUMONT for her comments on an earlier version of this article.

[1] Because Mali only recently rejoined the Union, this article discusses the Monetary Union only as comprised prior to June 1, 1984.

The first section provides an overview of the U.M.O.A.'s methods of operation. Sections II and III deal with the scope of the financial crises and the factors of internal economic policy that caused them. Section IV analyzes the results of the processes of stabilization and structural adjustment. Section V summarizes the major themes of the article and touches briefly on the remaining problems.

I - THE WHEELS OF MONETARY COOPERATION[1]

Although the cooperation between France and its African partners extends to all fields, monetary relations attract the greatest attention because they are what is unique about the U.M.O.A. and the Franc Zone in general. This cooperation is expressed in the affirmation of three major principles aimed at promoting economic development in a context of monetary stability:

(1) The franc C.F.A. is a currency common to all the member countries of the Union. Its rate of exchange with respect to the French franc is fixed. The current parity, 1 franc C.F.A. = 0.02 French francs, has not been adjusted since 1948. Modification of the parity is possible, however, but it requires the unanimous agreement of all parties concerned.

(2) Community management of exchange reserves. The Central Bank of the West African States (Banque Centrale des Etats de l'Afrique de l'Ouest - B.C.E.A.O.) keeps at least 65% of its official assets on deposit in an operating account opened on the books of the French Treasury. The unusual thing about this account is that it can be overdrawn by any amount as a result of

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1 For a detailed analysis of the institutional mechanisms of the Franc Zone, consult the work of Patrick and Sylviane GUILLAUMONT (1984).

the commitment undertaken by France to convert the African currency regardless of the amount of external liquid assets of its partners.

(3) Free transfer within the Zone, which cannot be violated, even if one of the countries is experiencing serious balance of payments difficulties.

The fact that the conversion guarantee applies only in the event of the depletion of all of the Union's consolidated external assets merely implies that the B.C.E.A.O., through the Operating Account Agreement, is answerable only to the French Treasury. This condition governing application explains why this guarantee did not come into play until December 1979, although Senegal and Benin had for several months been in a deficit position with regard to the issuing bank (Annex 1). It can be said, then, that the convertibility guarantee operates on two levels of intra-community solidarity: first, African solidarity when the B.C.E.A.O. operating account permits compensating for national positions on the debit side while remaining on the credit side itself; second, French solidarity whenever the international exchange reserves are depleted. This distinction between two levels of solidarity is a dangerous one to make, however, because it can give the impression that before 1979 France's exchange guarantee was useless. The mere fact that it could be enforced at any time helped to maintain confidence in the African currency, which enabled the countries to increase their external debt options.

In exchange for the unrestricted convertibility of francs C.F.A., the African countries are encouraged to exercise a form of monetary discipline aimed at establishing a certain price stability, as well as activating a warning system when the external exchange assets appear to be in danger of becoming depleted.

With regard to the determination of an adequate money supply, each country has a National Credit Committee (Comité National du Crédit - C.N.C.) which is responsible each year for establishing it on the basis of Gross Domestic Product price and volume growth projections and hypotheses of invariance of the ratio of money to the GDP (k) and the ratio (m) between the money supply and the currency in circulation (B). Given a projection of the variation of external assets (AEN) and the assistance to the government (CNG), the National Committee determines the increase of net economic credit (C) which is compatible with monetary equilibrium.

(1) $M^D = K . P. Y$ (demand for money equation)

(2) $M^S = B + D = AEN + CNG + C$ (equation for the supply of money and its equivalents)

(2') $M^S = m B$

(3) $M^S = M^D$ (monetary equilibrium equation)

(4) $C = M^D - AEN - CNG$ (equation for determining the total amount of credit in the economy)

Determined according to the principles of the quantitative theory of money, the overall monetary assistance to each economy is subject to the approval of the Board of Directors of the Central Bank, which may, if necessary, reduce it if the Union's exchange reserves require replenishment. Besides determining the level of annual assistance, the B.C.E.A.O. also has a full range of mechanisms enabling it at any time to make the necessary corrections to maintain monetary equilibrium. The principal mechanisms are: the prior authorizations required of commercial banks for any credit above a certain amount granted to an enterprise, direct interventions in the money market (open

market), and the possibility of establishing a system of compulsory reserves. In addition, the advances to each government are set at a maximum of 20% of the tax revenues of the preceding year. Although a similar limitation is included in the by-laws of most of the central banks, thus marking the issuing institution's independence from the public authorities, the by-law identifying the B.C.E.A.O. as a public international establishment guarantees observance of this provision.

Concerning the warning system:

- Article 51 of the by-laws of the Central Bank provides that the Board of Directors shall meet for the purpose of taking every appropriate measure whenever the ratio of the Bank's external holdings to sight liabilities reaches a level equal to or less than 20% for a period of at least 90 days.

- Article 20 of the treaty establishing the U.M.O.A. adds that in case of the depletion of liquid assets, the Central Bank must request transfer to it of the foreign currencies held by any agency under the jurisdiction of the Union.

In general, it can be said that the B.C.E.A.O. is theoretically provided with the means necessary to prevent large-scale monetary imbalances. Based on this observation, detractors of the Franc Zone have questioned the actual scope of the guarantee of unlimited convertibility of francs C.F.A. In fact, if the monetary discipline of the African partners is infallible, is not the overdraft of the operating account a figment of the imagination? (DIARRA, 1972; MARTIN, 1987). The experience of the last ten years removed any doubt on this subject once and for all.

II - THE DETERIORIATION OF BALANCES OF PAYMENTS IN EXTERNAL FINANCIAL CRISES

Although the Union was constantly in the red in foreign energy products trade, the first oil crisis had no significant effect on the balance of consolidated international payments. For the period 1973-1978, there was a surplus in the aggregate balance of approximately 50 million SDRs, the consequence of which was to build up exchange reserves and thus to improve the credit position of the operating account. However, this performance must be examined in greater detail (Tables 1 and 2).

a) Most of the States launched into a highly active external debt policy which considerably increased the vulnerability of their economies to fluctuations in the foreign environment. A tangible result of this policy was that investment and consumer expenditures rose sharply and, along with them, the current account deficit, the cumulative total of which reached 2 billion SDRs, or about 80% of the Union's average annual exports between 1973 and 1978.

b) Analysis by country reveals highly varied trends (Table 2). Until 1977, the Ivory Coast position remained satisfactory, due in part to the freezing of Brazilian coffee plants. This favorable international situation led to a sharp increase in world coffee prices and a considerable improvement in the Ivory Coast's external terms of trade. Conversely, Senegal and Togo were faced with serious financial imbalances even before the second oil crisis occurred.

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Table 1: Growth by period of Monetary Union compensatory financing (1970-1985)
(millions of SDRs)

	1970-1972	1973-1978	1979-1985	1983-1985
Current balance	- 297.3	- 2222.5	- 10176.4	- 2380.2
Fundamental balance	62.4	- 37.6	(...)	(...)
Aggregate balance	24.7	48	- 4842.8	- 2175.8
Compensatory financing (C.F.)	- 24.7	- 48	4842.8	2175.8
- Variations in foreign exchange holdings	- 58	- 287.5	7.8	- 241
- Operating account overdrafts	0	0	686.9	- 27.8
- Net position vis-à-vis the IMF	- 14.6	106.5	1054.5	261.7
- Structural adjustment loans and non-project loans:				
• World Bank	0	0	462.5	296.6
• CCCE	0	8.9	442.1	232.5
- Restructuring of external debt	0	0	1735.5	1403.9
- Outstanding external payments	0	33.1	389.2	199.1
- Miscellaneous	47.9	91.0	64.3	53.7
Compensatory financing (%)	100	100	100	100
- Variations in foreign exchange holdings	234.8	599	0.2	- 11.1
- Operating account overdrafts	0	0	14.2	- 1.3
- Net position vis-à-vis the IMF	59.1	- 221.9	21.8	12.0
- Structural adjustment loans and non-project loans:				
• World Bank	0	0	9.6	13.5
• CCCE	0	- 18.5	9.1	10.7
- Restructuring of external debt	0	0	35.8	64.5
- Outstanding external payments	0	- 69.0	8.0	9.2
- Miscellaneous	193.9	- 189.6	1.3	2.5
As a %				
Average of annual export compensatory financing ratios	- 6.1 *	- 0.1 *	13.8	17.1
Cumulative compensatory financing/ average exports	- 2.2 *	- 1.8 *	106.1	46.6
Note (average for the period)				
Exports of Goods and Services	1127.8	2720.7	4563.2	4667
Imports of Goods and Services	1370.4	3374.7	5690.5	5095
Gross reserves	258	331.4	362	434
Gross international reserves in import days	69	36	23	31

Source: - IMF: Balance of Payments Yearbook Statistics (various years); International Financial Statistics, 1986 Yearbook; Recent Economic Development (various years)
- Unpublished data: World Bank and Caisse Central de Cooperation Economique (Central Economic Cooperation Fund) for structural adjustment loans and non-project loans; Banque de France for the Operating Account

Comment: The aggregate balance is defined as the balance of all the separate operations.
* the (-) sign indicates an overall payments surplus

Table 2: Growth by country and by period of compensatory financing in the U.M.O.A. (1970-1985)
(in millions of SDRs and as a %)

	BENIN				BURKINA FASSO				IVORY COAST			
	1970 1972	1973 1978	1979 1985	1981 1985	1970 1972	1973 1978	1979 1985	1983 1985	1970 1972	1973 1978	1979 1985	1983 1985
Current balance (C.A.)	-7.4	270.3	-987.4	-251	12.2	-192.9	-407.9	-202.1	-230.6	-1589	-5443	-855.6
Fundamental balance	17.2	-184.1	-345.6	-206	11.4	-77.9	(...)	(...)	-37.7	373.3	-2993	-1122
Aggregate balance	14.1	-36.3	-256.5	-204.7	16.5	-23.6	-51.2	-14.5	-51.2	188.8	-2896	-1283.5
Compensatory financing (C.F.)	-14.1	36.3	256.5	204.5	-16.5	23.6	51.2	14.5	51.2	-188.8	2896	1283.5
- Variations in foreign exchange holdings	-13.5	14.3	9.4	0.3	-11.8	16.1	-75.5	-38.2	16.9	-273.6	323.1	-4.3
- Operating account overdrafts	0	0	67.6	46.2	0	0	0	0	0	0	366.8	-163.2
- Net position vis-à-vis the IMF	-0.7	5.5	13.1	3.1	-1.7	3.8	3.9	-4.2	-9.3	31.7	648.5	142.1
- Structural adjustment loans and non-project loans:												
• World Bank	0	0	0	0	0	0	0	0	0	0	161.1	240.2
• CCCE	0	0	0	0	0	0	24.6	8.6	0	0	376.1	108.7
- Restructuring of external debt	0	0	0	0	0	0	0	0	0	0	929.8	929.8
- Outstanding external payments	0	0	166.3	155	0	0	77.1	52.0	0	0	0	0
- Miscellaneous	0	16.5	0	0	-3.0	3.7	21.2	15.4	43.6	53.1	90.8	30.2
Compensatory financing (C.F.)(%)	100*	100	100	100	100*	100	100	100	100	100*	100	100
- Variations in foreign exchange holdings	95.7	39.4	3.7	0.1	71.5	68.2	-147.5	-114.0	33.0	144.9	11.2	-0.3
- Operating account overdrafts	0	0	26.4	22.6	0	0	0	0	0	0	12.7	-12.7
- Net position vis-à-vis the IMF	4.3	15.2	5.1	1.5	10.3	16.1	7.6	-12.5	-18.2	-16.8	22.4	11.1
- Structural adjustment loans and non-project loans:												
• World Bank	0	0	0	0	0	0	0	0	0	0	13	18.7
• CCCE	0	0	0	0	0	0	48.0	25.5	0	0	5.6	8.5
- Restructuring of external debt	0	0	0	0	0	0	0	0	0	0	32.1	72.4
- Outstanding external payments	0	0	64.8	75.8	0	0	150.6	155	0	0	0	0
- Miscellaneous	0	45.4	0	0	18.2	15.7	41.4	46	85.2	-28.1	3.1	2.4
- Average of annual export compensatory financing ratios (%)	-6.2	4.6	19.3	36.6	-17.0	-2.5	4.0	6.1	2.6	0.3	15.8	16.4
- Cumulative compensatory financing/ average exports for the period (%)	-17.7	29.9	135.9	105.8	47.0	28.1	30.1	18.9	8.6	-11.5	106.4	44.8
Note												
- Exports of Goods and Services (%)	79.7	121.3	188.7	193.3	35.1	84	170	177.6	596.6	1635	2721	2868
- Imports of Goods and Services	108.3	205.0	318.4	259.0	87.1	230	445	433.0	653.2	1717	3666	2910
- Gross reserves	22.1	19.2	11.5	3.0	41.0	54	76.7	106	96	132	24.9	9.4
- Petroleum products balance	-2.9	na	na	na	-4.3	-10.5	na	na	-21.3	-75	-168	-74.4
- Investment earnings balance	0.7	na	na	na	1.4	2.7	-1.5	-4.1	-9.5	-53.8	-383	-493
- Gross international reserves in import days	74	42	12	5	174	97	63	89	54.5	26	3	1

* Aggregate payments surplus

Table 2: Growth by country and by period of compensatory financing in the U.M.O.A. (1970-1985)
(in millions of SDRs and as a %)

	NIGER				SENEGAL				TOGO			
	1970 1972	1973 1978	1979 1985	1981 1985	1970 1972	1973 1978	1979 1985	1983 1985	1970 1972	1973 1978	1979 1985	1983 1985
Current balance (C.A.)	-27.4	-264.3	-874.1	-156.3	-31.7	-536.5	-1996	-802	-12.6	-227.3	-468	-113.2
Fundamental balance	59.4	55.4	-279.8	-102.6	19.7	-191.8	-931.4	-219.9	-7.6	-12.5	-583.5	-217.5
Aggregate balance	26.8	47.7	-185.4	-78.4	16.4	-116.8	-1069	-448.8	2.1	-11.8	-384.5	-126.3
Compensatory financing (C.F.)	-26.8	-47.7	185.4	78.4	-16.4	116.8	1069	448.8	-2.1	11.8	384.5	126.3
- Variations in foreign exchange holdings	-26.3	-57..6	-26.6	-78.0	-22.2	23.3	-0.1	1.1	-1.2	-21.0	-222.5	-121.9
- Operating account overdrafts	0	0	0	0	0	11.1	252.5	89.7	0	0	0	0
- Net position vis-à-vis the IMF	-0.7	2.5	71.7	33.4	-1.3	56.1	240.7	44.8	-0.9	6.9	77.2	42.5
- Structural adjustment loans and non-project loans:												
• World Bank	0	0	0	0	0	0	34.3	0.3	0	0	52.1	52.1
• CCCE	0	0	57.3	22.2	0	0	163.9	69.5	0	0	35.2	23.5
- Restructuring of external debt	0	0	100.1	91.8	0	8.9	357.3	217.3	0	0	348.3	164.9
- Outstanding external payments	0	0	0	0	0	0	28.4	26.0	0	0	117.4	-33.9
- Miscellaneous	0.2	7.4	-16.5	9	-7.1	17.5	-8.0	0	0	-7.2	-23.2	-0.9
Compensatory financing (%)	100*	100	100	100	100*	100	100	100	100*	100	100	100
- Variations in foreign exchange holdings	98.1	57.6	-14.3	-99.5	135.4	19.9	0	0.2	57.1	-17.8	-57.9	-96.5
- Operating account overdrafts	0	0	0	0	0	9.4	23.6	20.0	0	0	0	0
- Net position vis-à-vis the IMF	2.6	2.5	38.3	42.6	7.9	48.9	22.5	10.0	42.9	58.5	20.1	33.7
- Structural adjustment loans and non-project loans:												
• World Bank	0	0	0	0	0	0	3.2	0.1	0	0	13.6	41.3
• CCCE	0	0	30.9	28.3	0	7.6	15.3	15.5	0	0	9.2	18.6
- Restructuring of external debt	0	0	54.0	117.1	0	0	33.4	48.4	0	0	90.6	130.6
- Outstanding external payments	0	0	0	0	0	0	2.7	5.8	0	280.5	30.5	-26.8
- Miscellaneous	-0.7	7.4	-8.9	11.5	4.3	15.1	-0.7	0	0	-61.0	-6.0	0.7
- Average of annual export compensatory financing ratios (%)	-12.9	-4.1	7.5	10.3	-2.1	2.1	20.8	19.3	-0.9	0.2	15.3	13.9
- Cumulative compensatory financing/ average exports for the period (%)	-37.0	-29.4	46.9	22.5	-6.2	21.3	144.3	57.6	-0.7	6.9	110.5	41.8
Note												
- Exports of Goods and Services (%)	72.5	162.3	395	347.9	265.5	547.5	740.6	778	78.5	169.9	347.9	302
- Imports of Goods and Services	92.1	270.3	570	442	328.0	711.6	766.3	624	101.6	240.3	487.6	426.7
- Gross reserves	30.1	64	83.6	90.2	0	18	8	7	40	44	14	217
- Petroleum products balance	-3.9	-13.7	-70.9	-58.9	-5.8	-32.7	-110	-120	-3.5	-12.5	-28.4	-16.6
- Investment earnings balance	0.5	-1.8	na	na	-2.1	-14.0	-72	-99.8	-1.1	-3.5	-31.8	-42.6
- Gross international reserves in import days	39.6	75	57	77	30.3	9	4	4	143.7	81.8	118	186

Source: Same as Table 1
* Aggregate payments surplus

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As in the case of the Ivory Coast, but four years before the boom in major primary commodities exports, it was the foreign environment that precipitated the deterioration of the economic and financial position of these countries. In two cases the State had to deal with the collapse of world phosphate prices after a brief period of considerable increases.

Table 3

Growth of major export prices

Country	Products	Boom period	Price multiplier coefficient*
Ivory Coast	Coffee	1976-1979	1.45
	Cocoa	1973-74; 1977-79	1.47; 2.42
Niger	Uranium	1975-1983	3.5
Senegal	Phosphate	1974-1975	3.05
	Peanut oil	1974	1.49
Togo	Phosphate	1974-1975	3.05

Source: Taken from: World Bank, Price Prospects for Major Primary Commodities, 1984.
* Average prices during the worldwide boom as compared to the average prices for the 1970-1972 period.

This collapse had disastrous economic consequences because of poor planning on the part of the governments. The flow of tax revenues occasioned by the boom was in fact managed as though it were permanent, hence the upswing in investment programs and budget expenditures in general, accompanied by increased access to external debt. When prices suddenly plummeted, the tax revenues diminished rapidly and the prospects of external financing narrowed, while expenses remained abnormally high. This asymmetry of growth placed heavy strains on public finances.

The factors that led to the crisis in the economies of Senegal and Togo are also interesting because they illustrate a process of blockage caused by the public sector's lack of cash and not by the lack of foreign exchange, as is generally the case in developing countries outside the Franc Zone.

In 1978 the Treasury of Togo was unable to honor all of its obligations. Having reached the ceiling on cash advances from the Central Bank and unable in the short term to give the necessary flexibility to revenues and budget expenditures, the State was fell behind in their payments for the first time, while the private sector made it possible for the economy to accumulate new foreign exchange holdings. In Senegal, the same scenario unfolded, with the slight difference that the cash flow problem came later. Until 1980 the authorities were able to meet all of their external obligations; but Senegal's position in the operating account became negative in 1978.

With the deterioration of the international environment following the second oil crisis and the increased debt service burden, the U.M.O.A. entered an increasingly severe external crisis phase in 1979. Table 1, upon which the following commentary is based, was prepared to show the volume and structure of the resources mobilized to finance the imbalances. Two comments are in order concerning the step taken:[1]

a) First, callable payments were discussed. Since the balances of payments of the Union are generally prepared and published on the basis of payments made, it was therefore

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[1] Note that this step conforms to the regulations of the International Monetary Fund, as set forth in the: Balance of Payments Manual of (1977).

necessary to reconstruct the accounting documents in order to take into account in the deficit certain transactions which were not recorded because they did not involve disbursements (results of the rescheduling of debts, variations in outstanding external payments).

b) Second, it was thought proper to include in compensatory financing[1] certain long-term loans reserved exclusively for countries that had successfully restored their balance of international payments. The same was true of World Bank structural adjustment loans and non-project loans; but also, on the bilateral plane, of assistance of the same type which the French government was able to provide through the operations of the Caisse Centrale de Coopération Economique, whether under the heading of structural adjustment loans or sectoral loans.

For the 1979-1985 period, the amount of the consolidated overall imbalance in the Union's international payments is estimated at nearly 5 billion SDRs, or more than 100% of the average exports of goods and services for the period. The cumulative deficit in current transactions was even more astonishing since, using the same denominator, the percentage was 220%! Although all the financing mechanisms were called into play, their relative importance was modified as time passed, according to a strategy that duplicates the way crises are managed in most developing countries. In other words, the financing of deficits was at first dominated by unconditional facilities such as drawings on foreign exchange holdings and, in this case, the use of the special facility of overdrawing the Operating Account (1979, 1980).

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[1] The concept of "compensatory financing" as it is used here includes all of the sources of financing the disequilibrium in the balance of payments. The special mechanism of the compensatory financing of export earnings managed by the IMF is only a possible component of this type of financing.

The fact that the crisis in external payments and public finances affected several countries called for a large-scale mobilization of various types of conditional assistance from the IMF and the World Bank (1981-1983). With regard to the assistance from the Fund, this mobilization was effected to enable the B.C.E.A.O. to interpret its by-laws in a less stringent manner. In 1981, in fact, the Central Bank allowed public treasuries to obtain the counterpart in national currency of their drawings, independently of the cash advance ceiling of 20% of the tax revenues of the preceding year (L. GOREUX, 1985). This relaxation had become necessary. Without it, it is difficult to see what motivation the member countries would have had to negotiate programs with the IMF since, under the system of exchange of francs C.F.A., the external payments crisis could only have been caused by a scarcity of available funds at the State level. Certain observers, however, expressed disapproval, saying that this measure tended to give more weight to the State and, in the medium term, mortgaged the recovery of the Union's external position in conjunction with the phase of repurchasing national currency (B. VINAY, 1986). These concerns are no doubt justified. But, as will be seen in the following section, the situation prior to the programs was misleading and was characterized by a de facto lifting of ceilings together with growing external debt and, subsequently, overdue payments. The need to solve the cash flow crisis of the public treasuries forced such an initiative on the B.C.E.A.O. And to the extent that, in exchange for drawing rights, the member States were required to implement stabilization policies including: a program for retiring overdue public debt, strict control of external loans and economic credit, a more satisfactory distribution of monetary resources between the public sector and the private sector, it can be said that the resources of the Fund made a very positive contribution to alleviating the financial crisis while at the same time promoting economic reform.

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Finally, in 1984 and 1985, as a result of fewer possibilities of drawing on the various credit facilities of the Fund and the continuing problem of external debt, rescheduling became crucial. Since all dealings with the financial clubs of Paris and London are conditional upon the signing of a confirmation program with the IMF, it can be said that the withdrawal of the institution as a direct provider of resources was largely offset by the lever or "financial catalyst" effect of each agreement.

In the above general commentary, it was implicitly assumed that in the 1979-1985 period the Union constituted an economic unit characterized by uniform behavior with respect to the policy of financing the balance of payments. In reality, this assumption requires a certain degree of qualification (Table 2).

a) Not all of the countries were simultaneously affected by the financial crisis with the same intensity. As mentioned above, Togo (1977) and Senegal (1978) were hit by the crisis even before the second oil crisis erupted, which was not the case for Niger, where the strains on the balance of payments did not become apparent until the fall in uranium prices (1982). As for the Ivory Coast, given its central position in the Union, it is not surprising that its financial position directly influenced that of the U.M.O.A.

b) Although all of the countries were affected by the financial crisis, not all of them adopted the strategy described above. In fact, Benin and Burkina Fasso have so far rejected any adjustment program connected with the Fund. This refusal has made access to all balance of payments assistance impossible. The result of this has been to worsen the financial freeze, with a locking up of external accounts which can only be brought about by mounting internal and external payment arrears.

III - THE INTERNAL ORIGINS OF THE DETERIORIATION OF EXTERNAL ACCOUNTS

The weakening of the balances of payments was due to a number of factors. In the preceding section a brief account was given of the impact of the international environment, particularly as it related to the instability of foreign terms of exchange and, beginning in 1979, the growing debt service burden resulting partly from rising interest rates. This section will focus only on the share of responsibility falling to local economic measures, which leads to placing the emphasis on the risky nature of monetary and budgetary policies.[1]

On the monetary plane, circumstances necessitated that the reform of the U.M.O.A. take place in the midst of the oil crisis (1973-1975). In theory, this reform was to result simultaneously in decentralization of the monetary authority and reinforcement of the regulatory powers of the Central Bank, whose means of intervention were at that time expanded. In the specific international context of the 70's, these two objectives almost proved to be incompatible.

Through the National Monetary Committees responsible for determining the volume and distribution of credit according to the procedures briefly described in Section I, the governments adopted expansive monetary policies motivated by a desire to give money a more active role than it had in the past in the promotion of economic development.[2] The implementation of these policies

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1 Cf for an econometric analysis of the factors explaining the evolution of the Union's current accounts (PLANE, 1988).

2 This objective was raised again when the Council of Ministers of the U.M.O.A. resolved to implement the reform of May 2, 1975.

demonstrates implicitly that the authorities agreed with certain critical observers of the Franc Zone that the monetary stability of the 60's had been achieved at the expense of economic growth. In any case, when, between 1975 and 1978, the net foreign exchange holdings of the U.M.O.A. increased in conjunction with a positive trend in the terms of exchange, the expansion of internal credit was pro-cyclical, contributing to a rapid increase in the money supply, the average annual growth rate of which went from 14.5% between 1967 and 1973 to almost 30% in the 1973-1978 period. When, despite this, more lively economic growth did not occur, the result of this policy was to place strains both on local prices and on the Union's external position. The Central Bank could have tried to temper the boldness of the national monetary committees by neutralizing, through the growth of the internal counterparts of the money supply, the expansive effect of unexpected temporary booms on the primary commodities markets. But wouldn't this step have thwarted the desire to forge closer ties between money and economic growth? Wouldn't it have been misunderstood by the States inasmuch as neither the level nor the variation of the Union's foreign exchange holdings justified a squeeze on cash?

As circumstances would have it, the strains on foreign exchange holdings did not become apparent before the third quarter of 1979. In this context, the B.C.E.A.O. resigned itself to a "laissez-faire" attitude. This attitude of the Central Bank was criticized, as was a method of monetary programming excessively influenced by the momentary level of the Union's reserves and, therefore, too far removed from the consequences of economic policies on the medium-term growth of said reserves (KRUMM, 1985).

Although this criticism is justified, there is no proof that with a tightening of internal credit those involved would not have reacted by increasing their external debt. This comment supports the observation of Rattan BHATIA (1985) that the

effectiveness of the B.C.E.A.O.'s monetary control is asymmetrical since it seems all the more limited when the facilities of external debt are great.

In December 1979 the foreign exchange holdings of the Central Bank fell below the threshold of 20% of sight liabilities. Thus, the B.C.E.A.O. was again in a position of being able - if not compelled - to impose more restrictive monetary policies. At first, however, these measures were only diffidently applied. The Central Bank thus used all the latitude accorded it by Article 51 of its by-laws. Although, according to the by-laws, the Board of Directors is required to take every necessary step to improve the external position, it freely determines the means and the strength of its action. This moderately restrictive policy was dictated by the desire to cause only a gradual decline in liquidity ratios. A too sudden drop in these ratios would have involved tenuous liquidity positions and cash problems for everyone, including the banking systems. Unfortunately, the effect of this policy was not sufficient to check the development of illiquidity crises and the accumulation of arrears.

With regard to budgets, as mentioned in the analysis concerning the institutional mechanisms of the U.M.O.A., cash advances to public treasuries are limited by the by-laws to 20% of the tax revenues of the preceding year. This limitation, which is supposed to protect against drifts, was in fact circumvented in a number of ways. Only the four main ones are mentioned below:

a) In the B.C.E.A.O. accounts the credit granted to public enterprises was for a long time lumped together with private sector credit. This being the case, as soon as the States

encountered cash problems, the immediate solution was to encourage these enterprises to indebt themselves to the local banking system to compensate for an absolute reduction in operating subsidies or capital endowments. In practice, this tendency to utilize substitute sources of financing was all the less problematic since the States are majority shareholders in most of the commercial banks and the latter are in any case placed under the influential supervision of the Finance Ministry.

b) Without violating the 20% rule for advances from the Central Bank, the States were able to finance budgetary deficits by taking advantage of external loans. Rattan BHATIA (1985) has suggested that this system of placing a ceiling on advances was ultimately a factor in overindebtedness. This assertion must be viewed with reservations because without any regulation in this matter, two scenarios would have evolved, both demonstrating that external loans were finally necessary to finance expansive economic policies. In fact, either the States would have had to resort to an internal money creation even more vigorous than the one observed, but then the strains on foreign exchange holdings would have appeared well before 1979, which would have forced the B.C.E.A.O. to implement restrictive monetary measures earlier; or, for an equivalent growth of monetary resources, the States would have been compelled to ration internal credit to the private sector, but in this case the latter would have suffered from the eviction effect due to lack of access to international financial markets.

c) In certain States seasonal credits, for which there is no ceiling, were deflected from their original purpose, which is to facilitate the process of producing and marketing agricultural products. Logically, in fact, these credits are reversed within the year. The trend observed toward an increase in their amount shows that this was not always the case. The example most often cited is that of the National Office of Cooperation and Assistance for Development (Office National de Coopération et

d'Assistance pour le Développement - ONCAD). A semi-public institution, ONCAD was consistently able to finance operating deficits caused by the cumbersomeness of its structures with seasonal credits, which the agency was of course unable to repay on time (S. GUILLAUMONT, 1984; L. GOREUX, 1985).

d) The accumulation of payment arrears by most of the public treasuries was one way of financing budgetary imbalances, with the negative consequences for the overall functioning of the economies that one might expect. These arrears caused not only "carryover effects" but also "imitation effects" on the part of the other internal economic units (C. de BOISSIEU 1985).

IV - MEMBERSHIP IN THE MONETARY UNION AND THE IMPLEMENTATION OF ADJUSTMENT PROGRAMS

Because of the community management of the exchange reserves, a country with a temporary disequilibrium in its balance of payments has every chance of being able, regardless of the nature and the size of the deficit, to avoid the burden of a socially costly and economically useless stabilization. In the presence of a persistent external imbalance, the principle of community management is, however, of questionable interest since it can justify delays in the implementation of structural adjustment programs.

When the balance of the Operating Account is positive, through the action of compensations between national exchange positions, a country whose position is negative can in fact delay the adoption of corrective measures. No provision of the by-laws compels it to restore the balance of its international payments or to replenish its foreign exchange holdings.

When the balance of the Operating Account tends to become negative, the institutional mechanism obligates the Central Bank

to adopt the monetary measures necessary to correct the foreign exchange holdings position. But it is also true that the room for maneuver of the B.C.E.A.O. is great since access to overdrawing the operating account requires no formal agreement nor any involved negotiations on the content of the adjustment programs.

Be that as it may, it does not appear that the overdraft facility was used to circumvent the exigencies of adjustment. Although the operating account actually provided most of the compensatory financing in 1979 and 1980, the countries prey to more serious difficulties, with the notable exceptions of Benin and Burkina Fasso, availed themselves of the conditional assistance of the Fund in the first few months after the country's position became negative. Given that access to the overdraft facility is automatic and immediate, whereas establishing a program with the IMF is preceded by frequently lengthy and difficult negotiations, the time lag is not indicative of political reservations about adjustment. Thus, there was a relationship of complementarity rather than of substitution between these two sources of compensatory financing.

Beginning in 1983, stabilization and structural adjustment policies produced spectacular results. Expressed as a percentage of the exports of goods and services, the growth of the consolidated balance of current transactions exclusive of interest payments is evidence of this. From an average deficit of about 40% in 1982, this ratio dropped considerably and stayed below 7.5% in the last two years (1984-1985). The most remarkable progress was recorded in the Ivory Coast, Niger and Togo, where the position of the balance was even reversed, with a tenuous surplus after having been structurally passive since the middle of the 70's.

Conversely, in the countries not involved in an I.M.F. program, signs of a lasting adjustment are not yet visible, with

the result that their financial position is a source of legitimate concern.

Table 4

Ratio of current balances exclusive of interest payments to the exports of goods and services (as a %)

	1979	1980	1981	1982	1983	1984	1985	1979 1985	1979 1983	1983 1985
Benin	-13	-93.2	-111.1	-96	-61.3	-4.8	-16.9	-56.6	-74.9	-27.7
Burkina Fasso	-35.7	-24.3	-19.4	-48.6	-27.6	-36.1	-42.0	-33.4	-31.1	-35.3
Ivory Coast	-34.5	-41.2	-34.7	-18.8	-18	+13.7	+13.3	-17.2	-29.4	+3.0
Niger	-21.6	-31.9	-25.6	-37.4	-4.3	+10.7	+0.1	-15.7	-24.2	+2.2
Senegal	-22.3	-42.0	-47.6	-27.2	-26	-21.5	-17	-29.2	-33.2	-21.5
Togo	-60.3	-9.7	-1.8	-12	+2.1	+10.9	-1.6	-10.3	-16.3	+3.8
UMOA (average of ratios)	-31.4	-40.4	-40.0	-40	-22.5	-4.5	-10.4	-27	-34.9	-12.6

Source: IMF, Balance of Payments Yearbook Statistics, Washington, various years.
Comment: Investment earnings, lines 15-20 of the detailed balance of payments of the Monetary Fund are calculated exclusive of direct investment earnings.

By what means and at what social cost did the U.M.O.A. manage to improve the position of its external accounts? The process of restoring the balance involved a combination of measures, certain of which tend to check aggregate demand and others to stimulate the supply of exportable goods or substitutes for imports. Theoretical arguments suggest that the adjustment of international payments is more painful when devaluation is ruled out. For a "small country" that is a price taker on the international commodities market, devaluation is actually beneficial insofar as it instantly changes the structure of relative prices in favor of goods open to international trade. In an economy with large unused production capacities in this sector there is reason to hope that a not inconsiderable portion

of the adjustment can be accomplished by the growth of supply (structural adjustment) rather than the curbing of demand (stabilization).

With respect to the process of restoring the Union's balance, a few remarks concerning these assertions are in order.

First, in an international environment of flexible change where the French franc fell in value with respect to the major currencies (1981-1985), maintaining parity did not exclude a sometimes significant depreciation of the nominal effective exchange rates of the franc C.F.A. Calculated on the basis of the structure of the imports of each country during the 1980-1986 period, the depreciation was 6% between 1980 and 1987, and more than 10% not counting Benin, where the upward trend of the index was due in large part to the frequent devaluations of the Brazilian currency.

Table 5

Variations in percentage of the components of the real effective exchange rates of the West African Monetary Union (1980-1987)

	TEM	P.R.	T.E.R.
Benin	+16	-18.8	-2.8
Ivory Coast	-12.2	-5.8	-17
Niger	-8.9	-20.7	-24.5
Senegal	-6.3	+11.4	-5.7
Togo	-14.5	-2.0	-16.7
Burkina Fasso	-9.45	-10	-17.6
UMOA	-5.9	-7.6	-12.2

(Note: see legend on next page)

TEN: Variations in the nominal effective exchange rate calculated on the basis of the 1980-1986 average import structure.
PR: Variations in relative price expressed in the various currencies of the countries in question; the (+) sign indicates that inflation in the African country is higher than the average of its partners, and the (-) sign means the reverse. Consumer prices are the reference.
TER: Variations in the real effective exchange rate.
Source: Data from:
- IMF InternationaL Financial Statistics, 1988 Yearbook, Washington.
- United Nations, Yearbook of International Trade Statistics, New York, various years.
- World Bank, World Tables, 1989 edition.

Second, under the influence of internal policies, real effective exchange rates depreciated during the same period as that indicated above by more than 12% on average.

This trend toward improvement in the competitive position is remarkable in that it increases depreciation of the nominal effective exchange rate; this is a special case sufficiently rare to warrant mentioning. Usually, in fact, the increased competitivity instantly produced by a devaluation disappears in part in the ensuing months due to an acceleration in the rise of internal prices, which compound the difficulties of implementing a rigorous policy to accompany it. Now, in the case of the U.M.O.A., the depreciation of nominal effective exchange rates, without changing the parity, led, on the contrary, to a deceleration of inflationary strains. Two phenomena therefore contributed to this favorable development:

- the exogenous depreciation trend in the exchange rate of the French franc. Since the depreciation of the franc C.F.A. was

only indirect, it led to a phenomenon of money illusion on the part of the ecomomic units (PLANE, 1988).

- profound changes in the conduct of monetary and budgetary policies which led to a downward adjustment of inflationary expectations.[1]

Table No. 6 provides information for evaluating the comparative vitality of the reform processes south of the Sahara.[2] On average, the real effective exchange rate depreciated in the Union less quickly than it has since the beginning of this decade. The discrepancy has only limited significance, however. First because the World Bank index is based on the S.D.R., whereas for the Union the calculations are made on the basis of the currencies of the principal importing countries; but, more particularly, because many African countries outside the Franc Zone had to correct the excessive overvaluations that occurred in the 70's.[3]

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[1] Cf GUILLAUMONT (S): "Devaluation in Africa?" in Economic Observations and Diagnostics, Journal of the OFCE, October 1988, pp. 123-143.

[2] The data for Sub-Saharan Africa are taken from the World Bank and UNDP (1988) publication entitled: Adjustment and growth in Africa in the 1980's.

[3] Cf: Accelerated development in Sub-Saharan Africa, Action Program, World Bank, Washington, 1981.

Table 6

Indicators showing the results of reforms

Indicators	Periods	Sub-Saharan Africa Countries with energy reform programs	Sub-Saharan Africa Countries with no reform program or making few efforts	U.M.O.A.
Consumer price variations (annual %)	1980-85 1986-87	18 16	23 35	7.2 0.4
Nominal exchange rate (1980 - 82 = 100)	1986-87	48	55	97.3
Real effective exchange rate (1980 - 82 = 100)	1986-87	79	83	91.1
Central Bank real discount rate	1980-82 1986	-7.0 -1.0	-7.6 -12.2	2,8 8.8
Growth of the GDP (constant 1980 prices)	1980-84 1985-87	1.4 2.8	1.5 2.7	0.5 4.5
Growth of real investment	1980-84 1985-87	-2.1 -0.9	-3.7 -7.0	-19 3.7
Gross domestic savings (as % of GDP)	1982-84 1986-87	9.9 10.7	2.3 6.0	4.6 6.5

Sources: For general data concerning sub-Saharan Africa see Tables 19 and 20 of the World Bank document entitled: Adjustment and Growth in Africa in the 1980's (the averages are not weighted).
Calculations for the member countries of the U.M.O.A. are based on data from the World Tables of the World Bank, 1989 edition, and the IMF 1988 Yearbook: International Financial Statistics.
Calculations by country are given in Annexes 2-6.

The above observations are confirmed by the fact that between 1986 and 1987 the decline in real exchange rates in the Union was

due to price stability in an environment of worldwide disinflation. Conversely, the rate of price increases remained high in the other African countries, with the result that, on average, the currencies had to depreciate by about 50% with respect to their nominal value at the beginning of the 1980's in order to keep real depreciation at 20%.

As a result of price stability within the U.M.O.A. and a policy of tight money, the Central Bank's real discount rate is now positive at about 9%. Generally, it remains negative in most sub-Saharan countries, even in those which the World Bank considered as having undertaken energy reforms (cf. Table 6). Despite this policy of high interest rates, the rate of domestic savings is abnormally low in the Union, about 6.5% for 1986 and 1987. Financial crises characterized by the illiquidity, and even the insolvency of commercial banks cannot be considered as unrelated to this fact. Bankers not having taken the precaution of ensuring the security of deposits entrusted to them by the public, the temptation is now great for those who have no access to external financial markets to opt for the immediate use of savings. In this context of a highly specific crisis, it is not inconceivable that in the most recent period, the system of convertibility of francs C.F.A., which allows the unrestricted purchase of imported consumer goods, indirectly slowed the correction of national savings rates.

Judging from trends observed elsewhere, it does not appear that the refusal to adjust the parity of the franc C.F.A. led to any specific sacrifice in terms of the growth of domestic products. Of course, activity was unspectacular throughout the 1980-1984 period, but the impact of stabilization policies was intensified by the consequences of climatic disasters, especially in the Ivory Coast (1982-1984) and in Senegal (1980-1984). But, in the most recent period, a phenomenon of adjustment has occurred which is increasing the average performance of the

Union, placing it at a level higher than that achieved anywhere in sub-Saharan Africa.

IV - CONCLUSION

Local economic measures have contributed just as much as the international environment to the severe financial crises that most sub-Saharan countries have been experiencing for the past fifteen years. Although the desire to maintain the convertibility of the currency on the basis of a fixed parity vis-à-vis the French franc can encourage the conduct of a strict economic policy, the U.M.O.A. nevertheless lost considerable ground in the monetary and budgetary spheres. Given its economic and financial opening to the exterior, the effect of these policies was to lead immediately to balance of payments deficits. Between 1979 and 1985 the resources that had to be mobilized solely to finance the Union's international imbalances were estimated at approximately 5 billion SDRs, or more than 100% of the average exports of goods and services during the period.

In 1983, although national trends were fairly disparate, on the whole, policies aimed at restoring the balance of external accounts resulted in real progress. Since, in the 1981-1985 period, the French franc was frequently low vis-à-vis the major currencies and moderation in the creation of internal credit resulted in remarkable price stability, maintaining the parity of francs C.F.A. was compatible with a significant reduction in the real effective exchange rate. However, this approach, which is essential to the success of a structural adjustment, remains tenuous. And, in any case, some serious problems remain.

This is particularly true in the case of rehabilitating the banking systems, which is a factor in correcting the rate of national savings. There is also a need to continue reorganizing public finances and promoting the withdrawal of the State from

economic activities, whenever the private sector can effectively take over from the public administration. An obligation also exists to further improve the competitiveness of the economies. In a difficult international environment, because of the trend of primary commodities prices and the prospects of stabilizing the exchange rate of the French franc, this improvement will greatly depend on the ability to increase productivity in the productive system. And, finally, there are questions about the parity of the franc C.F.A. In terms of parity of purchasing power, the currency seems unaffected by any continuing overvaluation that would justify a departure from the current exchange rate with respect to the French franc. But, the aggressive monetary adjustments carried out in certain African countries, especially Nigeria, where the external value of the naira depreciated by half as compared to 1970, will undoubtedly cause problems. Certain French-speaking economies view with concern the development of clandestine trade on their borders which tends to accentuate the weakening of governments.

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Annex No. 1

GROWTH OF THE BCEAO OPERATING ACCOUNT

in millions of French francs

Year end	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Benin	32.9	57.6	58.3	29.6	- 57.7	15.4	296.3	- 78.1	- 384.7	- 388.1	- 456.3
Burkina Fasso	302.9	308	212.6	102.6	191	241.8	319.2	317.8	594.6	896	892.5
Ivory Coast	385.2	311.8	820.5	1,752.4	431.5	-2,136.4	-3,339.9	-2,981.2	-4,706.5	-3,531.4	-1,271.9
Mali (1)										+ 250.2	+ 84.5
Niger	191.3	372.3	432.8	485.2	470.9	500.3	514.9	98.4	329	749.5	+ 960.2
Senegal	122.3	118.6	148.6	- 62.1	- 323	- 637.7	-1,193.2	-1,020.4	-1,273.7	-1,027.6	-1,815
Togo	147.2	290.4	178.1	258	237.5	317	816.6	1,086.4	1,430.5	1,928.6	+2,237
Unallocated	123.4	- 39.9	- 247.3	- 78.7	142.5	646.4	869.7	1,021.9	103.7	- 560.4	+1,319.6
Total	1,305.2	1,418.8	1,603.6	2,487	1,092.7	-1,053.2	-1,716.4	-1,555.2	-3,907.1	-1,683.2	+1,950.6
Mali	- 763.1	- 919.8	- 837.4	- 862.7	- 936.1	- 985.9	-1,134.8	-1,211.4	-1,271.7		

(1) Mali rejoined the UMOA on June 1, 1984.

Source: Banque de France

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Annex No. 2 - Growth of the G.D.P.

Country	1980-1984	1985	1986	1987
Benin	3.3	7.8	0.7	- 3.7
Burkina Fasso	3.5	14.7	11.8	3.3
Ivory Coast	0.2	15.9	3.7	- 3.9
Niger	- 3.5	6.0	6.6	- 5.0
Senegal	3.4	3.8	4.0	6.2
Togo	- 4.3	2.8	2.5	1.9
U.M.O.A.	0.5	8.5	4.9	0.2

Source: From: World Bank, World Tables 1989

Annex No. 3 - Growth of consumer prices

Country	1980-1985	1986	1987
Benin	na	na	na
Burkina Fasso	7.7	- 2.5	- 2.8
Ivory Coast	5.5	6.6	5.4
Niger	5.0	- 3.2	- 6.8
Senegal	11.6	6.4	- 4.3
Togo	6.2	4.1	0
U.M.O.A.	7.2	2.3	- 1.4

Source: Idem Annex No. 2

Annex No. 4 - B.C.E.A.O. real discount rate

	1980-1985	1986
Benin	na	na
Burkina Fasso	2.9	11.6
Ivory Coast	5.1	2.9
Niger	5.5	16.4
Senegal	- 0.7	13.3
Togo	4.4	8.5
U.M.O.A.	2.8	8.8

Source: From: International Monetary Fund, International Financial Statistics, Washington 1988. The real rates are calculated using the formula:

$$r = \frac{1 + i}{1 + p} - 1$$

i: nominal interest rate
p: consumer price variation

Annex No. 5 - Nominal and real effective exchange rates
(base 100 = 1980 - 1982)

	Nominal exchange rate	Real exchange rate
Benin *	117.6	102.2
Burkina Fasso	93.6	89
Ivory Coast	91.5	85
Niger	94.2	76.7
Senegal	96.7	115
Togo	90.2	83.7
U.M.O.A.	97.3	91.1

Source: Idem Annex No. 2, No. 4 and Table No. 5
* The real exchange rate index is calculated using the Gross Domestic Product deflator.

Annex No. 6

Country	Real investment growth rate				Rate of gross domestic savings (% of GDP)			
	80-84	1985	1986	1987	80-84	1985	1986	1987
Benin	-23	+14.8	-3.3	+7.4	-4.8	-0.8	1	4.4
Burkina Fasso	3.8	+18	-11.1	-5.1	-7.1	-8.7	0	-7.4
Ivory Coast	-26.7	+47.6	-20.2	+9.5	20.5	25.7	23	18.6
Niger	-59.6	...	-34	+12.7	9	2.3	5.6	4.6
Senegal	3.3	-11.9	+13.6	+0.5	-2.3	-1.2	6	6
Togo	-12.2	+11.7	+4.3	-2.9	13.7	10.6	12.4	5.5
U.M.O.A.	-19	+16	-8.4	+3.7	1.3	+2.7	+8	+5.2

Source: Idem Annex No. 2

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Non Bank Financial Innovations in East Africa

by

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1. Introduction

In recent years there have been major moves by a number of African countries towards liberalizing their financial systems. In doing so there has been the belated recognization that real sector economic development and a free (or relatively free) financial sector are inextricably linked. While to some extent a major motivating force has been the conditionality requirements laid down as part of IMF and World Bank Structural adjustment programs, these developments would not have occurred without the endogenous acquiescence of the government (in some cases) and the endogenous motivation of the private sector (in others).

In section I of this paper I first look at theories explaining why financial innovations occur. As will be seen I define innovations broadly to include new instruments, institutions and processes. The two major theories of innovation are market completeness theory and constraint induced theory. These theories imply certain major causes of financial innovations. In Section II I will review the causal framework implied by these theories and look at the evidence from applying this framework to U.S. data. In Section III I examine this framework in the context of recent financial innovations in three East African countries, Kenya, Mauritius and Tanzania. It is shown that important additional causes (compared to the U.S.) of financial innovation are foreign exchange shortages and conditionality laid down by World Bank/IMF structural adjustment programs. Moreover, many of the financial innovations in East Africa are government sponsored (either directly or indirectly) whereas in the U.S. and other first world countries innovations are largely endogenous to the private-sector. In Section IV I will examine why some innovations succeed and others fail and link this to the interdependent nature of the financial innovations process. Finally Section V is a Summary and Conclusion.

II. Theories of Financial Innovation

(i) Market Completeness

Market Completeness theory has its theoretical foundations in the work of Arrow and Debreu. Basically in a complete market there are a sufficient number of financial instruments available (e.g., stocks, bonds, futures, options) to hedge every conceivable "state of the world" that might arise. For example, a commodity price collapse, oil shock, rapid economic growth are different potential states of the world with different probabilities of occurance. Thus, in this context, an incomplete or imperfect financial market is one where there are insufficient instruments available to enable individuals to hedge state contingent risks if they so wished. Hence financial innovations (new products, instruments) can be viewed as a process of completing the market i.e. developing (in the limit) a sufficient number of financial instruments to span the whole state space (feasible set of state outcomes). In general it has been shown (see Arditti and John [1980] for example) that the number of financial instruments (m) necessary to span all state possibilities (n) is not one to one. That is by combining (diversifying across) financial instruments such as options and futures it is possible to create synthetic securities that hedge certain potential risks (states). Hence in general m is less than n.

Van Horne (1984) has provided a more practical interpretation of market completeness theory. He views financial innovations as a mechanism by which economic agents (individual's, firm's or government) can improve their return/risk trade-offs. Market completeness occurs when no (new) innovation can improve this trade-off. Further, the incentive to innovate will increase the greater the range of possible outcomes or states facing the investor. Thus, for example, a major spur towards completing the market through innovation is greater price (interest rate, goods price, exchange rate) uncertainty since this expands the feasible set of possible outcomes in the state space.

(ii) Constraint Induced Theory

This theory developed by Silber (1975, 1983) views agents as maximizing their utility or wealth subject to a set of regulatory and economic constraints. Economically, one can think of agents maximizing their utility in the context of a linear-programming type model. According to Silber, the more binding the set of constraints the greater the incentives for agents to innovate new financial instruments and processes to avoid these constraints. Hence this is a theory of constraint induced innovation. Importantly, not only do restrictive regulations, such as foreign exchange controls, interest rate ceilings and taxes spur innovations (to avoid such regulation) but so do economic constraints. Thus increased interest rate or price volatility is viewed as imposing increased constraints on an agents' actions induc ing him to innovate new instruments or processes to alleviate such constraints.

Elsewhere Kane (1981) has given a slightly different interpretation of the constraint induced theory of regulation. Kane conjures up the notion of a "regulatory dialectic." Basically, governments impose restrictions on financial activities which induce agents to innovate ways around these constraints. This, in turn leads governments to impose restrictions on any new set of activities. Consequently regulatory avoidance is viewed as the major spur for innovation -- which is speeded up by improvements in technology. That is, Kane views technology as a mechanism by which agents can respond (through new innovations) to government regulation and re-regulation.

While it is difficult, if not impossible, to directly test the market completeness innovation theory and difficult to test the constraint induced theory (see Ben-Horim and Silber (1977) for the only known test) these theories are useful in that they suggest a framework of causes that can be employed to explain different financial innovations. While this framework is to some extent ad hoc it does offer a significant improvement on simply descriptively listing financial innovations as separate or independent events.

II. The Causal Framework for Financial Innovations

The underlying theories of financial innovation suggest a number of major causes of financial innovation. In particular, from the work of Van Horne (1984), Silber (1983) and Finnerty (1988), who seek to explain financial innovation in the United States, a set of major causes can be identified.

(1) Inflation and the level of Interest Rates

The higher the rate of inflation the greater the incentives of agents to innovate financial products that lock-in a real rate of interest or at the very least a nominal interest rate that is responsive to inflation. Also the more costly it is for lending agents to adhere to interest rate ceilings.

(2) The Volatility of Prices and Interest Rates

The greater the volatility of prices and interest rates the greater the risk faced (by risk-averse agents) and the greater are the incentives to innovate new instruments or products to hedge such risk (e.g., futures, options, swaps).

(3) Tax Laws

The higher are tax rates either on income (dividends and interest) or capital gains the greater are the incentives to develop innovations to lower the tax burden (e.g, zero coupon/deep discount bonds)

(4) Regulation

Regulation encompasses both ceilings (such as those on savings deposit and loan interest rates) as well as activity constraints (such as permitted areas of lending or investing). The more costly it is for an agent to adhere to such restrictions, either in lost income or profits, the greater the incentive to innovate new activities lying outside the boundaries of current regulation (e.g., NBFI finance companies).

(5) Technological Advances

The greater the speed with which information can be collected and transactions processed the lower the (average) cost of introducing new innovations and the lower the cost of regulatory avoidance.

(6) Level of Economic Activity

The greater the level of economic activity (and therefore the greater the level of savings) the greater is the demand for new innovations as investment vehicles. Also the greater the opportunities to mobilize new savings.

(7) Other Causes of Innovation

These include: internationalization, reduced agency costs, increased liquidity, academic work and accounting benefits.

If (1) to (7) are the approximate causes of financial innovations how can the different innovations be classified? The two broadest classifications schemes are those that are new products or instruments and those that are new processes or institutions. In turn new products could be further divided into those that are consumer orientated products (i.e. new types of savings accounts) and those that are corporate or government orientated products (e.g. corporate bonds).

In this paper I will use a three part classification scheme:

(1) Consumer Innovations

(2) Corporate/Government Innovations

(3) Financial Process Innovations

In Tables 1, 2, 3 applications of this causal framework to recent financial innovations in the U.S. are shown. Specifically, Table 1 shows the analysis of major causes of innovation by Silber (1983) for the period 1970-82, Table 2 shows the analysis of Van Horne (1984) for the period 1978-84 and Table 3 shows the analysis of Finnerty (1988) for the period 1968-1988. These tables are fairly easy to interpret. Thus Silber (1983) argues that 3 major causes for the innovation of zero-coupon deep discount bonds were: the level of interest rates, tax effects and the volatility of interest rates, while Van Horne (1984) attributes the same innovation to the level and volatility of

(7) Foreign Exchange
(8) IMF/WB - Structural adjustment

interest rates and (perhaps surprisingly) academic work. While, Finnerty (1988) attributes zero coupon bonds to the level and volatility of interest rates, tax effects and risk reallocation effects. Thus, although there is agreement that the level and volatility of interest rates were a major cause of this innovation, there is some disagreement over the other causes. This of course, is partly due to the rather ad hoc link of this framework to the underlying theoretical models and the difficulty of developing more direct tests of the innovations process.

Notwithstanding, the essentially ad hoc nature of this framework, I will examine, in the next section, how well it fits recent experience in three East African countries: Kenya, Mauritius and Tanzania.

(III) Application of the Causal Framework to East Africa

In Section II, six major causes of financial innovations in the U.S. were identified: (1) Inflation and the level of interest rates, (2) Volatility of prices and interest rates, (3) Tax laws, (4) Regulation, (5) Technological advances and (6) The level of economic activity. If the theories of financial innovations are general, (1)-(6) should explain a large number of East African financial innovations. However, two important causal constraints that are very relevant for African countries (but not so relevant for the U.S.) need to be added.

Specifically:

(i) Foreign Exchange Constraints

The greater the shortage of foreign exchange receipts (due either to commodity price falls and/or export collapse) and stringency of exchange controls, the greater the incentives for agents to develop methods to either avoid such controls and/or innovate new methods to collect foreign exchange.

(ii) IMF and World Bank Structural Adjustment Programs

The greater the conditionality imposed by Structural Adjustment Programs (linking additional hard currency loans to financial liberalization) the greater the incentive for

agents to avoid even more binding foreign currency constraints by adhering to a liberalization program.

Thus (i) and (ii) add an international or foreign currency dimension to the causes of financial innovation in African countries. In addition to these other causes, the question of who does the innovating also appears to be somewhat different between the U.S. and African experience. Virtually all the innovations in Tables 1-3 (for the U.S.) can be attributed to private-sector initiatives in response to the causal factors. By contrast many of the financial innovations recently witnessed in East African countries are government (or para-statal) sector initiatives. This suggests that, since the U.S. and East African financial markets are at very different stages of development , government sponsoring of innovations may be necessary at early stages of financial development but that eventually the private-sector has sufficient profit incentives and motivations to be the primary (if not the sole) source of financial innovation. Of course, one problem with non-private sector driven innovations, by governments seeking social rather than profit objectives, is that such innovations may have a greater propensity to fail a market test than commercially driven innovations -- although privately sponsored innovations can and do fail as well.

The three East African countries analyzed are at different stages of financial liberalizaiton: Tanzania (just beginning to liberalize), Kenya (in the middle of liberalizing) and Mauritius (undertaking major reforms to its financial sector). While these countries have different political ideologies as well as per capita incomes it is of interest to examine what common threads the "Causal Framework" offers in explaining major financial innovations in these countries over recent years. It should be stressed that the list of innovations, while fairly comprehensive, is probably incomplete and the attribution of causes to innovations is based on my judgement and in a number of cases is probably contentious.

Table 4, summarizes the major innovations in three countries: Kenya (K), Mauritius (M) andTanzania (T), by breaking down the innovations into three different classifications:

(1) consumer product innovations

(2) commercial product innovations

(3) financial processes innovations.

And, identifies eight potential causes of innovation:

(1) Inflation and the level of interest rates

(2) The Volatility of Prices and Interest Rates

(3) Tax Laws

(4) Regulation

(5) Technology

(6) Level of Economic Activity

(7) Foreign Exchange Constraints

(8) IMF and World Bank Structural Adjustment Programs

Moreover, innovations are further subdivided as to whether they are "largely" government sector driven or sponsored (G) or private-sector driven or sponsored (P). Finally while informal foreign currency black markets and lending markets are geniune "innovations", I concentrate on more formal innovations only. (However, black markets can easily be explained within this causal framework).

INSERT TABLE 4 ABOUT HERE

First, looking at consumer sector financial innovations, (1) and (2) are savings bonds introduced by the government of Mauritius in 1987 and 1988. Both bonds were introduced as a means of absorbing private sector savings and to increase competition for savings with the banking sector. In the first issue of these bonds (8 year maturity) the zero coupon (deep discount) form proved nearly 10 times more attractive than the 8 year coupon bearing bonds (Rs. 235 million versus Rs. 27.5 million). As Table 4 indicates, the major difference between these instruments is that the zero's allow the investor to avoid tax while, with the coupon bearing bonds, the buyer has to pay income tax on coupons. Here high income tax rates is not only a major cause of this innovation but also (legal) tax avoidance is a major reason for this innovation's relative success. The next innovation is the increasing use of credit cards and Travel and Entertainment cards (particularly American Express). This is made possible by the use of satellite technology that allows a US cardholder, for example, to use his card for expenditures in

Kenya etc... Moreover, such cards are an effective source of foreign currency for foreign exchange constrained countries such as Kenya and Tanzania. Finally, to the extent that economic activity and per capita income is rising they increase payments convenience by relieving the constraint of having to hold and pay for goods and services in cash. As might be expected credit cards are (relatively) more widely used and distributed in Mauritius than in Kenya or Tanzania, where the per capita level of economic activity is higher. The fourth consumer innovation is mutual funds. As part of its stock market reform package, the government of Mauritius through the State Commercial bank and State Investment Corporation are sponsoring the sale of open-ended mutual fund shares. The advantages of a mutual fund is that it allows investors to better diversify stock price risk (cause (2)), while exploiting technology that allows the value of the mutual fund portfolio to be marked to market in a frequent fashion -- (cause [5]). In addition, mutual funds become an extremely attractive vehicle for investors when there is a rising level of economic activity and an expanding volume of savings (cause [6]). The fifth consumer innovation is interest bearing checking accounts recently introduced by Citicorp in Kenya. Rising levels and volatility of inflation and interest rates clearly increase the opportunity cost for holding non-interest bearing checking accounts (causes [1] and [2]) which is accentuated if there are also regulations regarding ceilings for maximum interest payments on the nearest available substitutes such as savings deposits (cause [4]). In particular, in periods of inflation individuals (savers) prefer explicit payment of interest rather than payments in kind such as low service charges etc.

The second group of innovations are commercial product innovations. In 1988 the Mauritius Leasing Corporation was established. Since this corporation was not a bank it could not raise,because of regulation, finance through deposits (cause [4]). Instead it made a 5 year maturity, 11 1/2% coupon, corporate bond issue that paid coupons competitive with bank savings rates and T. bill rates -- although not as competitive as the rates on the zero coupon savings bonds discussed earlier (cause [1])

Both Mauritius and Kenya have leasing companies -- the second commercial innovation. In Mauritius this is an independent financial institution while in Kenya they are subsidiaries of the major banks (e.g. Standard and Chartered). The major reasons

for leasing companies being established and thriving in both Mauritius and Kenya are tax advantages either to the lessor in (Kenya) or lessee in (Mauritius) -- cause [3]. Leasing is also a mechanism of regulatory avoidance (cause [4]) in that it allows agents to avoid restrictions on bank's holding (directly) real long-term equity in their asset portfolios.

Venture capital involves the participation of an outside investor or group of investors in the equity of small/risky projects or firms. Thus long-term equity participation differentiates a V.C. firm from a bank that makes short-term loans to small business (although if a loan goes bad a bank will end up, ex-post, with an implicit equity participation in the company). As with leasing, venture capital firms such as IPS (K) in Kenya are a form of regulatory avoidance (i.e. of limits) on banks directly holding real equity in their portfolios. Further, because of the high risk nature of most venture capital projects it is only by careful selection, close-monitoring and diversification that a VC firm can survive the high risk of such investments -- which in turn are the reasons for its existence (cause [2]).

The absence of bank finance to small companies is widely seen as a constraint to financial and real development in many African countries. Banks, particularly in Kenya, Tanzania and Mauritius, seem to concentrate on making relatively short-term loans to large scale private and parastatal customers. This leaves only the high interest in - formal credit market sector as a source of loan finance to small scale enterprises (SSE's). The role of guaranteed loans, as in Kenya, is to reduce the cost of funds (relieve the constraints implied by causes [1] and [2]) to small business by offering banks a risk-sharing or co-insurance default risk guarantee. In addition such guarantees allow banks to avoid coming up against regulated maximum loan rate ceilings (cause [4]).

The third set of financial innovations are broadly defined as new or reformed financial processes. Although Mauritius has had a stock market for over 100 years, by the end of 1987 it was totally moribund and was ill-serving the rapidly growing real sector of the economy. Thus to better accommodate a growing level of economic activity and demand by firms for long-term funds (cause [6]) which, because of regulation and inertia, were not being accommodated by the banking system (cause

[4]), the government has sponsored a major reform of the stock market. This includes building a new exchange, the establishment of a SEC, a complete body of new laws (modelled on the US) as well as reformed trading practice. It was felt that without undertaking such reforms the financial sector would prove a drag on the continued development of the real sector.

Because of foreign exchange regulations (cause [4]) and foreign exchange shortages (cause [7]), corporations in many African LDC's have had great difficulty importing key raw materials and other vital imports. Development banks that are funded by foreign currency loans (provided by overseas sponsors such as the World Bank, CDC, EEC, etc...) are often viewed as a financial innovation that partially alleviates these foreign currency constraints. This IDB and DFCK in Kenya and TDFL in Tanzania are development banks built on this model. However, while these development banks may be an innovation that has alleviated certain foreign currency shortages they have also raised new problems and constraints, such as enormous interest and principal foreign currency burdens for indigenous firms, in the face of major devaluations of local currencies. This suggests that the success of one financial innovation may crucially depend on (be interdependent with) the presence of other innovations. In this specific case, instruments that allow indigenous firms to hedge foreign currency risk (see next section on sources and failure of financial innovations).

A third recent financial process innovation has been offshore banking. Mauritius has recently passed legislation to allow the establishment of off-shore banks. An off-shore bank is basically a shell-organization that attracts foreign currency deposits from non-indigenous agents (e.g. capital flight) and on-lends these deposits to other non-indigenous agents, and/or , in the case of Mauritius, to provide foreign currency short-term working capital loans to EPZ (export processing zone) firms. As such, off-shore banks are innovations to alleviate foreign currency shortages (cause[7]) and to avoid regulations such as limitations on indigenous agents ability to borrow or hold foreign currencies abroad (cause [4]). Moreover, they may enable the financial sector to better accommodate real sector needs for expansion (cause [6]).

Merchant banks are a specialist group of financial institutions who provide longer-term finance (i.e. longer than commercial banks) to the real-sector of the economy.

This longer-term finance may include venture-capital like equity participations or longer-term loans. However, in the case of Diamond Trust of Kenya, recently voted the most innovative financial institution in Kenya, the services provided also include underwriting equity issues -- such as the new issue or IPO of its sister company Jubilee Insurance. Thus, merchant banks are an innovation that can be attributed to regulations limiting the ability of commercial banks to provide long-term financing (cause [4]) as well as to the level and volatility of interest rates (causes [1] and [2]) that may make new equity issues more attractive sources of finance than longer-term debt or loans. However, only two new equity issues have been made (underwritten) by merchant banks in Kenya in recent years mainly because of an unavoidable regulatory constraint that allows a government sponsored Capital Issues Committee to decide on when (and at what price) a new private equity issue can be offered to the public.

Finance companies (often labelled NBFI's) are an additional innovative financial process. Finance companies exist in Kenya, Mauritius and Tanzania. While, like banks, they often issue savings deposits (but not checking accounts) they tend to concentrate their lending either on asset backed commercial finance (e.g. financing inventories of goods) or asset backed consumer finance (e.g. hire purchase). One of the major reasons for their establishment has been regulatory avoidance of interest rate ceilings on bank savings and/or lending rates (cause [4]). Thus in Kenya during periods of rising interest rates (cause [1]) during the 1980's the ceilings on bank savings and lending rates became increasingly binding. By establishing NBFI (Finance) subsidies banks could get around such ceilings. Moreover, even when (as in the Kane regulatory dialectic) regulators sought to impose ceilings on NBFI lending rates these ceilings were still 4-5% higher than bank lending rates so that "institutional arbitrage" remained attractive. Thus, regulatory avoidance has been a major cause for the establishment and growth of NBFI's.

The final two process innovations are financial market innovations. It is in this area that IMF/World Bank structural adjustment programs (cause [8]) appear to have had most effect in driving financial innovations. Thus as part of its structural adjustment programs Kenya has introduced longer-term Treasury bonds sold through a discriminatory auction thereby increasing the menu of longer-term financial assets. In

such an auction, subject to minimum price (maximum yield) constraints the investor (agent) is free to enter a competitive bid for a desired quantity of bonds. While there are some technical problems with the current auction procedures the major advantages of these competitive auctions is that they allow investors to better manage interest rate risk (causes [1] and [2]). An additional aspect of the Kenyan structural adjustment programs has been the start of a nascent secondary market in T. bills as a precursor of an eventual reorientation of monetary policy, away from credit ceilings and controls, towards a policy based on open market operations (i.e. a monetary policy more consistent with a liberalized financial sector).

Summary

In the above section it has been shown that East African financial innovations, broadly defined, fit quite well into the causal framework suggested by the complete market and constraint induced theories of innovation. Specifically, a relatively limited set of causes appear to offer a reasonable explanation of a wide array of innovations. While it is impossible to reach anything other than qualitative conclusions it does appear that regulatory avoidance (cause [4]) and the level and volatility of prices and interest rates (causes [1] and [2]) are prime determinants of the scale and scope of financial innovation in these countries.

In the next section we look at the reasons for the success and failure of financial innovations. That is, even though a financial innovation appears it may well fail through lack of demand or inefficient (cost effective) supply.

IV The Success and Failure of Financial Innovations

Table 4 listed 16 financial innovations. In most cases these innovations are so new that it is hard to say whether they will be successes or failures (e.g, Off-shore banking and/or stock market reform in Mauritius). However, in other cases it is possible to see why (explain why) an innovation has failed or succeeded.

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Failures

(1) Mauritius Coupon-bearing Savings bonds

As discussed earlier Mauritius coupon bearing savings bonds attracted relatively little investor interest. The reason for the failure of this innovation is that it was clearly dominated by the zero-coupon savings bonds issued at the same time. In particular, the zero coupon bond offered the same nominal gross yield with greater interest rate risk protection and after tax returns. In the terminology of the complete market paradigm the coupon bearing savings bonds were redundant securities in that the zero coupon savings bonds dominated in terms of return-risk trade off. Thus a new innovation will tend to fail whenever its return-risk characteristics are already closely replicated by an existing financial instrument or some combination of existing financial instruments. Or, put slightly differently, a successful financial innovation should offer investors a new risk-return trade-off.

(2) Foreign Currency Funded Development Banks

Although the innovation of foreign currency funded development banks are, a priori, important innovations in reducing capital market incompleteness (by supplying longer-term finance in hard currencies to foreign currency constrained indigenous importers) it is also arguable that they have exacerbated market incompleteness by expanding the range of foreign currency risks faced by indigenous borrowers. In the case of Kenyan and Tanzanian development banks, large proportions of their loan portfolios are in arrears or in default. While, in others funds remain unborrowed. If well developed forward foreign exchange markets (currency futures or options) were available to indigenous firms in these countries -- then firms may be able to cover some of their foreign exchange rate risk by taking a position in the forward market e.g. buying foreign exchange forward 3 months to meet an expected foreign currency denominated interest payment in 3 months to time (see Saunders (1989)). Unfortunately, the one way downward path in the spot exchange rates of many African countries viz a viz the dollar (and other hard currencies) has meant that no agent (Central bank or commercial bank) has desired to act as the counter-party in forward market transactions (notwithstanding foreign exchange control restrictions on such markets). For such markets to exist there must be some finite probability that the spot rate might appreciate

instead of just depreciating in the near future and the future supply of foreign exchange must be reasonably guaranteed (i.e. it must be deliverable).

As a result the relative success or failure of one financial innovation (in this case foreign currency backed development banks)is intimately linked (interdependent) with the successful innovation of other financial instruments -- i.e., foreign exchange risk hedging instruments such as forwards, futures or option contracts. Thus for some financial innovations there is an unavoidable degree of jointness inherent in evaluating their potential success.

Success

Venture Capital

IPS(K) the private venture capital firm in Kenya has been highly successful. Clearly venture capital is not a "redundant security" in a Kenyan context because of the very limited alternative suppliers of equity. In particular, although there is a stock market in Kenya, which lists some 55 stocks, this has been virtually moribund with only two new issues since 1980 and a trading volume of no more than a few thousand shares per year. Thus any innovation that provides a new source of long-term equity in local currency is likely to be successful as long as the V.C. firm closely monitors and keeps track of the chosen projects and picks the projects based on commercial criteria alone (a failing of many local currency development banks) i.e., using net present value criteria with discount rates sufficiently high to reflect the appropriate private degree of project risk.

In sum, as the three cases above imply, the sources or failure of financial innovations appear to depend on two key features:

(1) the relative uniqueness of the innovation i.e. lack of redundancy in terms of its risk/return trade-off

(2) the degree of independence of the innovation in terms of its risk-return performance, from other innovations or potential innovations

(V) Summary and Conclusions

In this paper recent financial innovations in East Africa have been identified. To better understand these innovations an analytical framework was used that had links to the underlying theories of financial innovation. Using this framework it was shown that a relatively small number of causes could explain innovations and that many innovations resulted from either initiatives to escape economic and/or regulatory constraints -- such as inflation, foreign exchange shortages and interest rate ceilings. This framework was additionally useful in identifying reasons for the relative success or failure of financial innovations.

TABLE 1—FINANCIAL INNOVATIONS: 1970–82

Types	Exogenous Causes[a]							
	1							
	(a)	(b)	(c)	2	3	4	5	6
A. Cash Management								
1. Money Market Mutual Funds	✔							
2. Cash Management/Sweep Accounts	✔				✔			
3. Money Market Certificates	✔					✔		
4. Debit Card	✔				✔			
5. NOW Accounts	✔							
6. ATS Accounts	✔				✔			
7. Point of Sale Terminals					✔			
8. Automated Clearing Houses					✔			
9. CHIPS (Same Day Settlement)					✔			
10. Automated Teller Machines					✔			
B. Investment Contracts								
(*i*) *Primary Market*								
1. Floating Rate Notes				✔				
2. Deep Discount (Zero Coupon) Bonds	✔		✔	✔				
3. Stripped Bonds	✔		✔	✔				
4. Bonds with Put Options or Warrants	✔			✔				
5. Floating Prime Rate Loans				✔				
6. Variable Rate Mortgages				✔				
7. Commodity Linked (Silver) Bonds				✔				
8. Eurocurrency Bonds	✔						✔	
9. Interest Rate Futures				✔				
10. Foreign Currency Futures							✔	
11. Cash Settlement (Stock Index) Futures						✔		
12. Options on Futures				✔		✔		
13. Pass-Through Securities						✔		
(*ii*) *Consumer-Type*								
1. Universal Life Insurance				✔				
2. Variable Life Policies		✔						
3. IRA/Keogh Accounts			✔			✔		
4. Municipal Bonds Funds			✔			✔		
5. All-Saver Certificates	✔					✔		
6. Equity Access Account		✔		✔				
C. Market Structures								
1. Exchange-Traded Options								✔
2. Direct Public Sale of Securities								
Green Mountain Power Co.				✔				
Shelf Registration				✔		✔		
3. Electronic Trading								
NASDAQ					✔			
GARBAN					✔			
4. Discount Brokerage						✔		
5. Interstate Depository Institutions					✔	✔		
D. Institutional Organization								
1. Investment Bankers/Commodity Dealers	✔			✔				
Salomon/Phibro, Goldman Sachs/J. Aron, DLJ/ACLI								
2. Brokers/General Finance								✔
Shearson/Amex, Bache/ Prudential, Schwab/Bank of America								
3. Thrifts with Commercial Banks	✔			✔		✔		
4. Financial Centers (Sears Roebuck)								✔

[a]Column headings: 1. Inflation: (a) Level of Interest Rates, (b) General Price Level, (c) Tax Effects; 2. Volatility of Interest Rates; 3. Technology; 4. Legislative Initiative; 5. Internationalization; 6. Other.

Table 1 Source: Silber (1983)

Table 2

A Partial Listing of Recent Financial Innovations (1978–1984)

	Primary Cause[a]
Products	
Money market investment accounts	1, 2
Super NOW accounts	1, 2
Interest rate and stock index futures markets	1, 2, 6
Options on futures contracts	1, 2, 6
Municipal bond mutual funds	1, 3
Zero coupon bonds and coupon stripping	1, 6
Adjustable rate preferred stock	1, 3
New variations of adjustable rate mortgages	1, 2, 6
Securitization of pass-through and other mortgages	1, 2, 5
IRA accounts	3
Universal life insurance policies	1
Currency option loans	1
Interest rate swaps and currency swaps	1
Forward interest rate loan contracts, with ceilings and floors	1
Bonds with put options	1, 3
Issuance of and investment in high-yield (junk) bonds	1, 6
Processes	
Automatic teller machines	2, 4
Point-of-sale terminals	4
Financial transactions by personal computer	4
Shelf registrations	2
Electronic security trading	2, 4
Electronic funds transfer	4
New variations in credit card processing	4

[a] Cause notation: 1, volatile inflation and interest rates; 2, regulatory; 3, tax law change; 4, technological advance; 5, level of economic activity; and 6, academic work.

Table 2 Source: Van Horne (1984)

TABLE 3. Factors Primarily Responsible for Financial Innovations

Source: Finnerty (1988)

Innovation	Factors Primarily Responsible*	Innovation	Factors Primarily Responsible*
Consumer-Type Financial Instruments			
Broker cash management accounts	7	Money market mutual funds	6,7
Municipal bond funds	2,4,6	Money market accounts	6,7
All-saver certificates	6,7	NOW accounts	6,7
Equity access account	1,6,8	Bull/Bear CDs	2
Debit card	2,7,11	IRA/Keogh accounts	1,6
Tuition futures	4,8	Universal or variable life insurance	1,7,3
Variable or adjustable rate mortgages	7	Convertible mortgages or reduction option loans	2,7
Securities			
Deep discount/zero coupon bonds	1,4,7	Stripped debt securities	1,4,7
Floating rate notes	4,5,7	Floating rate, rating sensitive notes	3,4,5,7
Floating rate tax-exempt notes	4,5,7	Auction rate notes/debentures	2,3,4,7
Real yield securities	2,4,5,8	Dollar BILS	4,7
Puttable-extendible notes	2,3,4	Increasing rate notes	3
Interest rate reset notes	3	Annuity notes	11
Extendible notes	2,4	Variable coupon/rate renewable notes	2,4,6
Puttable/adjustable tender bonds	2,4,7	Variable duration notes	4,7
Euronotes/Euro-commercial paper	2,4	Universal commercial paper	4
Medium term notes	2	Negotiable CDs	2,5
Mortgage-backed bonds	4	Mortgage pass-throughs	2,4,5
Collateralized mortgage obligations	2,4,5	Stripped mortgage-backed securities	4
Receivable-backed securities	4,5	Real estate-backed bonds	4,5
Letter of credit/surety bond credit support	4,11	Yield curve/maximum rate notes	4,6,7
Interest rate swaps	4,6,7	Currency swaps	4,6
Interest rate caps/floors/collars	4,7	Remarketed reset notes	2,3,4
Foreign-currency-denominated bonds	4,7	Eurocurrency bonds	7
Dual currency bonds	4,6	Indexed currency option notes/	
Commodity-linked bonds	4,6,8	Principal exchange rate linked securities	4,6,7
Gold loans	4,8	High-yield (junk) bonds	2,5,7,9
Exchange-traded options	4,9	Foreign currency futures	4,9,11
Interest rate futures	4,7,9	Stock index futures	4,8,9
Options on futures contracts	4,7,9	Forward rate agreements	4,7
Warrants to purchase bonds	4,7	Adjustable rate preferred stock	1,4,5,6,7
Convertible adjustable preferred stock	1,4,5,7	Auction rate preferred stock	1,4,5,7
Remarketed preferred stock	1,4,5,7,11	Indexed floating rate preferred stock	1,4,5,7
Single point adjustable rate stock	1,2,4,5,7	Stated rate auction preferred stock	1,3,4,5,7
Variable cumulative preferred stock	1,2,3,4,5,7	Convertible exchangeable preferred	1,2,10
Adjustable rate convertible debt	1,10	Zero coupon convertible debt	1,11
Puttable convertible bonds	3,4,7	Mandatory convertible/equity contract notes	1,6
Synthetic convertible debt	1,10	Exchangeable auction preferred	1,2,4,5,7
Convertible reset debentures	3	Participating bonds	3,4
Master limited partnership	1	Additional class(es) of common stock	11
Americus trust	4,6	Paired common stock	4
Puttable common stock	3,4,10		
Financial Processes			
Shelf registration	2,6,7	Direct public sale of securities	2,6
Discount brokerage	2,6	Automated teller machines	2,11
Point-of-sale terminals	11	Electronic security trading	2,11
Electronic funds transfer/		CHIPS (same day settlement)	7,11
automated clearing houses	7,11	Cash management/sweep accounts	7,11
Financial Strategies/Solutions			
More efficient bond call strategies	7,9	Debt-for-debt- exchanges	1,7,10
Stock-for-debt swaps	1,7,10	In-substance defeasance	1,7,10
Preferred dividend rolls	1	Hedged dividend capture	1
Leveraged buyout structuring	1,9,11	Corporate restructuring	1,9,11
Project finance/lease/			
asset-based financial structuring	4		

*Notation: 1. tax advantages; 2. reduced transaction costs; 3. reduced agency costs; 4. risk reallocation; 5. increased liquidity; 6. regulatory or legislative factors; 7. level and volatility of interest rates; 8. level and volatility of prices; 9. academic work; 10. accounting benefits; and 11. technology.

TABLE 4 FINANCIAL INNOVATIONS IN EAST AFRICA

INNOVATIONS	COUNTRY[1]	CAUSES[2]	SECTOR SPONSOR[3]
A. CONSUMER PRODUCTS			
1. SAVINGS BONDS	M	1, 2, 6	G
2. ZERO - COUPON SAVINGS BONDS	M	1, 2, 3, 6	G
3. CREDIT CARDS	M, T, K	5, 6, 7	P
4. MUTUAL FUNDS	M	2, 5, 6	G
5. INTEREST-BEARING CHECKING ACCOUNTS	K	1, 2, 4	P
B. COMMERCIAL PRODUCTS			
1. CORPORATE BONDS	M	1, 4	P
2. LEASING	M, K	3, 4	P
3. VENTURE CAPITAL	K	2, 4	P
4. GUARANTEED SMALL BUSINESS LOANS	K	1, 2, 4	G
C. PROCESSES			
1. STOCK MARKET REFORM	M	4, 6	G
2. FOREIGN CURRENCY FUNDED DEVELOPMENT BANKS	M, K, T	4, 7	G
3. OFF-SHORE BANKING	M	4, 6, 7	G
4. MERCHANT BANKING	K	1, 2, 4	P
5. FINANCE COMPANIES	K, M, T	1, 4	P
6. TREASURY BOND AUCTIONS	K	1, 2, 8	G
7. T. BILL SECONDARY MKT.	K	8	G

1988

stick w/ good banking services

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NOTES

1. K = KENYA , M = MAURITIUS, T = TANZANIA

2. CAUSES:
   1 = Inflation and the Level of Interest Rates
   2 = The Volatility of Prices and Interest Rates
   3 = Tax Laws
   4 = Regulation
   5 = Technology
   6 = Level of Economic Activity
   7 = Foreign Exchange Constraints
   8 = IMF/World Bank Structural Adjustment Programs

3. P = Private Sector Sponsor, G = Government Sector Sponsor

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