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USAID/Lesotho

FINANCIAL MARKETS SEMINAR

PROCEEDINGS

Draft Final Report

October 8, 1992

Office of Government Services
1801 K Street, N.W
Washington, DC 20006
Telephone 202 296 0800

Price Waterhouse

October 8, 1992

Mr. Curt Reintsma
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RE: USAID/Lesotho Financial Markets Seminar
Financial Sector Development Project
Contract No. PDC-2206-Z-00-8191-00

Dear Mr. Reintsma:

Enclosed please find five copies of the draft final of the Proceedings of the Financial Market Seminar. Please provide us with your comments, so that we can proceed with the final version and provide you with enough copies for distribution to the participants in the seminar.

It was a pleasure to assist you and the Central Bank of Lesotho with this seminar.

Sincerely,

J. Richard Breen
Director
Financial Sector Development Project

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1. INTRODUCTION

On May 25-27, 1992, the Central Bank of Lesotho, with the support of the U.S. Agency for International Development (USAID) in Lesotho, hosted a financial markets seminar. The objective of this seminar was to involve leaders in both the public and the private sectors in a dialogue that would lead to a process of financial markets policy development and reform.

Price Waterhouse was contracted by USAID through the Financial Sector Development Project (FSDP) to provide a coordinator and two speakers for the seminar: one on financial market development and another on rural finance and targeted credit. Dr. Yoon Park, the Research Director of FSDP and Dr. Laura Viganó of Finafrica were the featured speakers.

The body of this report summarizes each speaker's presentation and the ensuing discussion. Following the opening address on the importance of financial markets, presentations were made on the following topics:

- Overview of Financial Markets
- The Role of Finance in Economic Development
- Targeted Credit Schemes
- Regional Influences on Local Financial Markets
- Macroeconomic Policy and Financial Markets
- Informal Finance and Rural Development
- Emerging Financial Markets in Southern Africa

At the conclusion of the seminar, participants were asked to identify the three most important areas in which follow-on actions should be taken. Twenty-one participants answered the questionnaire, and their responses are presented at the end of this report.

The Appendices include the program agenda, the list of participants, a blank questionnaire form and copies of six papers presented at the conference.

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2. PROCEEDINGS

2.1 Opening

Dr. A.M. Maruping, the Governor of the Central Bank of Lesotho, welcomed participants and introduced the seminar by discussing the important role of financial markets in structural adjustment, public confidence, and growth.

The official opening address was delivered by the **Honorable A.L. Thoahlane**, Minister of Finance and Planning. The Minister, after discussing the importance of financial markets, emphasized that more progress could be made in developing Lesotho's financial markets. He asked the group to consider the following four questions:

- "Are present institutional structures adequate for the present and future development of Lesotho? If not, how and to what degree should they be strengthened to be able to perform efficiently from now on?"

- "Does Lesotho have enough institutions to play the role of financial intermediaries? Are these institutions doing enough to mobilize savings from both formal and informal financial sectors?"

- "Are available instruments and services in the market adequate to meet the needs of all categories of present and potential participants in the market?"

- "What mechanisms are there for matching the needs and requirements of lenders and borrowers of all categories?"

The Minister closed his remarks by stressing the importance of maintaining and improving current macroeconomic policies, especially monetary policy, conducive to financial market development.

The Minister's full address is presented in Appendix D.

2.2 Overview of Financial Markets

Dr. Yoon Park of Financial Markets International Research Institute (FMIRI) set the stage for the seminar by presenting an overview of financial markets. He categorized financial markets as money and capital markets, each with its related instruments and institutions.

Money market instruments include treasury bills and notes, bankers' acceptances, federal funds, commercial paper, certificates of deposit, repurchase agreements, and short term loans. Money market institutions and instruments include the Central Bank, commercial banks, investment and merchant banks, finance companies, money market, mutual funds and pension funds.

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Capital markets provide long-term and risk capital. The instruments include debentures, equity-linked bonds, and common and preferred stock. Capital market institutions include investment and merchant banks, stock exchanges, insurance companies, pension funds, and primary and secondary securities markets.

In recent years, there has been tremendous growth in international financial markets. Among the markets and instruments discussed are those under the general rubric of euromarkets, such as eurocurrency, eurobonds, eurocredits, floating rate notes, euronotes and euroequities. Dr. Park also discussed financial derivatives such as futures, options, and swaps.

2.3 The Role of Finance in Economic Development

In Dr. Park's second presentation, he discussed the role of finance in economic development from the 1950s through the 1990s. He then offered policy suggestions for financial market development.

Dr. Park termed the 1950s and 1960s the *colonial financial era*. This period was characterized by large foreign-owned bank branches in the capital or port city of a developing country which provided trade finance services to foreign companies.

The 1960s and 1970s, years Dr. Park termed the *post-independence period*, were characterized by bank nationalizations. Nationalized banks usually supported government-centered economic strategies and often were used to finance official budget deficits. Banking and credit policies during this period employed controlled interest rates, often at negative real rates. Directed credit programs were also common during the 1960s and 1970s. The combination of these and other policies often resulted in capital flight, real-estate speculation, a mushrooming of informal finance, non-performing loans and loan losses.

The disappointing results of this period contributed to the world debt crisis of the early 1980s. Lending from international commercial banks dried up and levels of official funding diminished. These combined forces meant that financial systems in developing countries needed to find new sources of funds. This spurred a renewed interest in developing domestic financial markets.

In the 1980s and 1990s, governments around the world reacted by adopting reforms that included the following:

- financial restructuring and privatization of banks;
- diversification of the assets and liabilities of government-owned banks, particularly development finance companies;
- deregulation of interest rates;

- promotion of competition through new bank licenses and reduction of barriers to entry;

- establishment of non-bank financial institutions such as leasing companies, venture capital companies, mutual funds, and insurance.

Dr. Park reiterated the importance of these policy areas and presented five fundamental keys to financial market development.

1. Financial markets cannot be developed separately from concomitant macroeconomic reforms. Financial reform is not a panacea; reforms that affect inflation, exchange rates, prices and budget deficits must also be forthcoming.

2. Interest rates must be liberalized and directed credit programs must be scaled down.

3. Financial infrastructure must be strengthened.

    a. Information must be available and reliable. Accounting and auditing standards must be established.

    b. Legal systems must be adequate in the area of company, banking, securities, and bankruptcy law.

    c. Regulatory systems must strengthen prudential regulations and supervision over the banking system.

4. Financial institutions must be developed. These include modern and computerized stock exchanges, brokerage houses, and investment banks.

5. Financial systems must be internationalized. The advantages of internationalization include economies of scale, potential technology transfer, and potential capital infusions for the reflow of flight capital. There is also a downside to internationalization: exposure to international risk. Dr. Park presented a model of *degree of internationalization and financial deepening* which is illustrated below and presented on the following page.

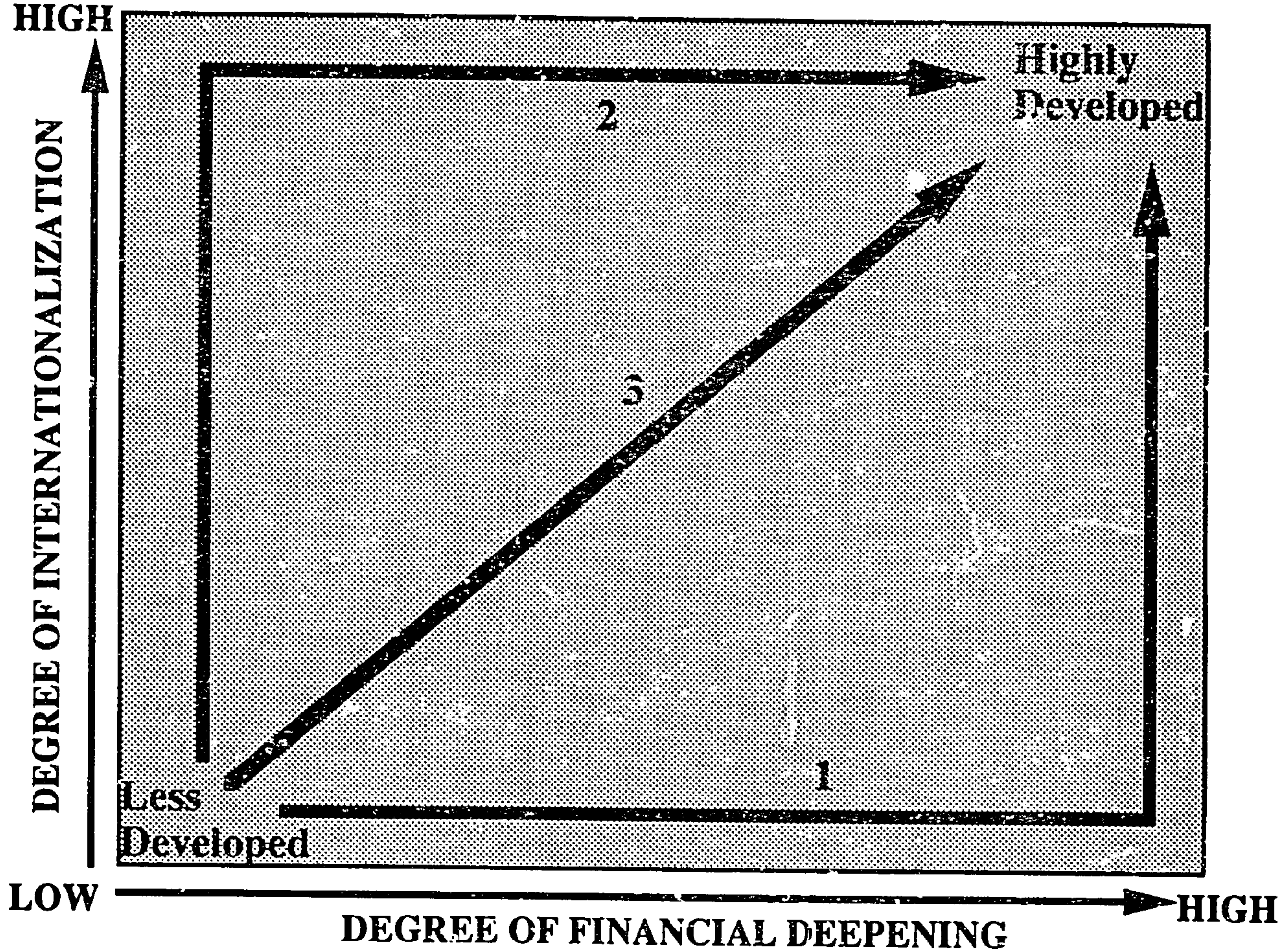
This model demonstrates three approaches:

1. **The gradualist approach** calls first for deepening the financial sector, then, once it is strong enough, opening it up to international competition. This approach was utilized by Japan, Korea, and Taiwan.

2. **The internationalist approach** calls for letting in foreign actors to help pry open the market. This approach has been followed by Chile and Guatemala.

3. **The big bang approach** involves doing everything simultaneously and is being used by Poland and Hungary.

APPROACHES TO FINANCIAL MARKET DEVELOPMENT



1 = *GRADUALIST* APPROACH

2 = *INTERNATIONALIST* APPROACH

3 = *BIG BANG* APPROACH

2.4 Targeted Credit Schemes

Dr. Laura Viganó of Finafrica, University of Bergams, Italy, introduced her presentation by stating that targeted credit projects often fail because of their terms and conditions of evaluation. Frequently, targeted credit schemes interfere with bank management and impose conditions that are inconsistent with the long-term financial viability of intermediaries. Since many targeted credit schemes have low repayment rates, borrowers are not induced to behave efficiently. This results in failure to repay loans, which has a negative impact on bank portfolios. In short, the end result of many targeted credit programs is that banks lose their autonomy and little economic development benefit is derived.

Borrowers under targeted credit schemes default because there is a disparity between what beneficiaries need and what banks offer, and because they perceive the costs of default to be lower in the formal financial sector than in the informal financial sector.

Given this backdrop, Dr. Viganó then offered five important goals for successful credit projects:

- the role of credit is to create a financial network that is effective in servicing customers;
- human resources involved in credit projects should be trained to know the market;
- the size of the credit project should be appropriate to the intermediary institution and the borrower;
- the financial intermediary utilized for onlending targeted credit should be financially viable;
- conditions of onlending should be at market rates.

Dr. Viganó stressed that when banks lend at market rates, they can afford to mobilize resources competitively in the market.

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Finally, Dr. Viganó presented a formula for determining the net margin on intermediation, which incorporates all the costs of intermediating targeted credit:

	Revenue from Lending
LESS	*Costs of Borrowing*
=>	**Margin on Intermediation**
LESS	*Provisions for Loan Losses*
=>	**Net Margin on Intermediation**

This formula demonstrates that although financial institutions may borrow at very low or subsidized rates, the low cost is offset by the high cost of loan losses to the institution.

In conclusion, she stated that targeted credit programs should avoid intervening in bank management; credit lines should aim at developing financial infrastructure, rather than onlending; and that financial institutions should not be used to meet social goals.

Following Dr. Viganó's presentation, a panel session on targeted credit was chaired by **Dr. K.J. Moyana**, the Governor of the Reserve Bank of Zimbabwe. Other participants in the panel were **Dr. A. Maleiane**, the Governor of the Central Bank of Mozambique, **Mr. Murray Gardiner** of USAID, **Mr. S.K. Phafane** of BEDCO, and **Mr. N. Monyane** of the Lesotho Bank.

Dr. Maleiane spoke about Mozambique's negative experience with targeted credit schemes at low interest rates. He cited the example of a credit program (with a repayment rate of 0.5%) targeted to former freedom fighters. He termed this kind of credit program an "individual adjustment program" and noted that it is motivated more by political will to help the poor than to improve the financial system.

Mr. Gardiner described how credit unions, which play an important role in the informal financial sector, have sometimes been used as delivery vehicles for targeted credit. Onlending schemes have damaged the core funding of credit unions and affected their assets. When donors withdraw, the onlending institution often becomes bankrupt. Mr. Gardiner suggested that it is important to build better personnel skills within onlending institutions, that the price of lending should be based on the cost of intermediation, and that lending programs should respond to the needs of the rural community and ensure that management is responsible to its members.

Mr. Phafane said that the experience of BEDCO has been quite poor in terms of loan repayment. He further stated that lending at subsidized interest rates is ill conceived since an entity unable to pay market rates is not a viable venture. BEDCO has also experienced problems in the use of extension services to provide credit. He went on to say that governments should try to reduce dependence on transfers and closed his comments by saying that credit is not a panacea.

Mr. Monyane said that the Lesotho Bank has run several exogenously motivated targeted credit schemes. He said there were three main reasons why targeted credit programs tend to go wrong: (1) a perceived need that targeted groups should be stimulated via credit; (2) a range of incompatible forces, such as political aims, a bank's need to be profitable, and a donor's need for evidence of contributing to development; and (3) a reluctance to shut down an ailing institution. Exit barriers are high and legal machinery governing foreclosure is insufficient.

2.5 Regional Influences on Local Financial Markets

Dr. Laurence C. Clarke, the Deputy Governor of the Central Bank of Botswana, discussed Botswana's experience in financial market development. Currently, Botswana has six commercial banks (two British, two South African, one Zimbabwean, and one Australian), four development finance institutions, three insurance companies, and several brokers, pension funds, and finance companies as well as a healthy emerging share market.
An inhibiting factor in the development of Botswana's financial markets has been the government's role in accumulating revenue in a revenue stabilization fund. While this fund has yielded many benefits, it has crowded out private sector access to credit for agriculture, housing and small-scale industry.

Among the important new developments in Botswana's financial sector has been the issuance of Bank of Botswana Certificates which are used to absorb liquidity and facilitate market-determined interest rates. Moreover, the Central Bank's supervisory capabilities and powers have been strengthened and have allowed the Central Bank to take control of BCCI's chartered bank in Botswana and liquidate it. This has been an important step in building confidence in the banking system at a time when funds have been moving from real assets to financial assets.

Dr. Clarke discussed a number of areas in which financial deepening must continue:

- capital market development;
- interest rates that are positive in real terms;

- open flows of information and collaborative establishment of rules governing this information in the region;

- regional cooperation, particularly in the regulatory area.

In terms of regional cooperation, Dr. Clarke envisions great prospects for collaboration at the banking level. First, in many of the countries in the region there are South African and/or Zimbabwean banks. Second, technological development is catalyzed by the influence of foreign banks. Finally, there is a great opportunity for regional regulatory arrangements. He also noted, however, that this process will necessitate the liberalization and/or abolishment of exchange controls.

Dr. Clarke concluded by saying that regional cooperation in the financial sector is critical. His full presentation is contained in Appendix D.

A panel, chaired by Dr. Maleiane, including Dr. Park and Mr. T.M. Borotho, the Research Director of the Central Bank of Lesotho, discussed Dr. Clarke's paper. **Dr. Maleiane** emphasized that while financial liberalization is good, the capacity to monitor and supervise it is crucial. He also agreed that financial policies should be harmonized within the region.

Dr. Park suggested that a regional financial center in southern Africa should be developed to promote regional financial integration, technology transfer and economies of scale. This would enable regional stock exchanges to develop, if they are not yet developed nationally, and would help in long-term bond issues that may be regionally but not locally feasible.

Mr. Borotho presented some comments regarding Lesotho. Mr. Borotho emphasized that Lesotho is a very small country, and that, owing to its geographical location vis a vis the Republic of South Africa (RSA), Lesotho's economy is very open and highly vulnerable to exterior influences. Prior to Lesotho's independence, both countries operated as one economy with one currency. There were no restrictions or controls over the movement of people and goods. Following independence, Botswana, Lesotho and Swaziland each introduced their own currencies, exchangeable at par. Swaziland, then Botswana, withdrew from the arrangement in 1974/5, yet Lesotho's currency, the loti, is still linked to the rand at par.

Financial markets in Lesotho and South Africa are still closely linked. For example, in the money market, Lesotho does not determine interest rate policies. Due to the free movement of funds between Lesotho and the RSA, when interest rates decrease in Lesotho vis-a-vis South Africa, depositors move funds to the RSA. In order to retain funds, the Central Bank needs to make sure that Lesotho interest rates do not diverge significantly from those of the RSA. Certain rates are determined locally (for example, the savings rate and the prime rate) but it is still necessary to watch the RSA where, generally, the rate is slightly lower. In the area of *exchange rate policy,* the loti is set at par with the rand; therefore, Lesotho has no

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choice but to follow rand's movements. By international standards, Lesotho is plagued by a high inflation rate.

Mr. Borotho concluded by saying that is essential for countries of the region to work together. He stressed that the first step is to try to harmonize policies within the region, so all can work in the same direction.

2.6 Macroeconomic Policy and Financial Markets

Mr. P. Molapo of the Central Bank of Lesotho discussed monetary policy. He stated that the usual indirect tools of monetary policy, open market operations, liquidity ratios, and discount rates, are difficult to employ effectively in LDCs. Rather, LDCs depend on moral suasion and direct tools of monetary policy, including credit controls. He also said that direct instruments, while easy to work with and explain to politicians, cannot be used indefinitely.

Current monetary policy in Lesotho has five main goals: price stability, improvement in the balance of payments position, restriction of domestic credit growth to a rate compatible with economic growth, promotion of investment, and improved industrial access to capital markets.

Mr. Molapo's detailed paper is included in Appendix D.

Dr. Moyana, provided background on the macroeconomic environment in Zimbabwe. In Zimbabwe there are five commercial banks, as well as various finance houses, merchant banks, building societies, money market institutions, and discount houses. The country is pursuing growth-oriented economic policies focused on increased investment and the development of equity markets. Zimbabwe is following an IMF economic program, and among the steps it has taken are signing MIGA arbitration accords, liberalizing the foreign investment regime, removing many controls on the financial sector, and liberalizing imports. Even so, Zimbabwe's high budget deficit (9% of GDP) is causing inflation.

Dr. Moyana went on to discuss some challenges which Zimbabwe faces:

- maintaining a balance between fiscal and monetary policy;
- encouraging savings, which does not appear to be very price elastic;
- eliminating credit controls;
- liberalizing cross-boarder investment.

Dr. Moyana's paper is included in Appendix D.

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Mr. L.T. Thuoane, the Permanent Secretary of Finance of Lesotho then described Lesotho's economic condition. Lesotho's budget deficit, M14 million, is financed by borrowing in the form of public and compulsory savings, treasury bills, and from the external sector, mostly at concessional rates.

Governor Maruping, who preceded his comments with the disclaimer that he was speaking as an economist and not for the Central Bank of Lesotho, stated that it is a mistaken view that there is no scope for monetary policy in Lesotho. Dr. Maruping emphasized that since late 1968 the government has been exercising monetary policy and has made significant progress in sterilization. He said that the exchange rate is not entirely unrelated to government policies nor is it artificial because of the high economic interaction between Lesotho and the RSA. He pointed to the absence of a parallel market to demonstrate the appropriateness of the exchange rate. He said that savings were not that sensitive to interest rates because savings are used as demand deposits in the banks of Lesotho (there is no alternative investment choice for the depositors).

He characterized the three commercial banks in Lesotho as three monopolies, each with its own segment of the market. The Central Bank of Lesotho has had to fill the gap left by commercial banks with targeted credit schemes. He emphasized that experience has shown that credit schemes should operate on a market basis and be used only as catalysts.

2.7 Informal Finance and Rural Development

Dr. Viganó began her presentation by listing the characteristics of borrowers in informal financial markets:

- they are generally small-scale entrepreneurs;
- they use debt for emergency purposes and only in the short-term;
- they have difficulty in forecasting cash flows;
- they have variable revenue.

Therefore, when evaluating credit risk, these customers' credit profiles are characterized by low and variable revenues; a blur between the household and business economic units; and lack of information. This makes it very difficult for banks to evaluate true creditworthiness.

The informal financial sector finds other ways of evaluating creditworthiness. In informal financial markets, there is an abundance of information because there is personal knowledge of the individual and a certain amount of information available on profitability and entrepreneurship. Credit risk is better contained because lending is done on flexible terms and contracts' conditions are adapted to the customer.

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Informal financial intermediaries fall into four categories:

1. Individuals lending for solidarity purposes. This type of lending is characterized by immediate disbursement. The repayment may be in kind, but the contract is verbal. Credit evaluation is based on personal knowledge and social pressure insures repayment of the loan.

2. Individuals lending as a profession. These include money lenders and owners. These loans are characterized by immediate disbursement, flexible maturities, fixed repayment dates, very high loan charges and inconsistent repayment procedures. While the loan agreement is verbal, it is made according to an established process by well-known players with the credit evaluation based on indicated information only. Most of the lenders are *usury lenders*.

3. Groups created for various purposes and financial intermediation. These are often professional groups and trade unions. These loans are characterized by quick disbursement (although not as quick as 1 and 2), flexible maturities, repayment based on honor and the credit evaluation based on personal knowledge.

4. Groups created to perform financial intermediation. These are informal groups formed to educate members regarding savings and credit. Repayment is monthly, and the depositors have passbooks. The disbursements take longer but are still quicker than banks, and repayment is rewarded with continued access to credit. Written loan agreements, credit evaluation based on personal knowledge, and indicators such as past performance as a depositor are hallmarks of this category.

While the lending rates charged by informal financial institutions appear to be high, they are comparable to those charged by development banks when all the transactions costs are factored in.

Dr. Viganó summed up by asking, "What can banks learn from the informal financial sector?" She presented two options:

- **Banks can open branches and imitate the informal market.** In such an arrangement, loan contracts would be based on personal knowledge and have flexible interest rates and terms. Since, building branches and training a knowledgeable staff is very costly, she suggested that donors help subsidize these costs. Opening local branches operating at market rates would be preferable to using existing banks to onlend at discounted rates.

- **Banks can use existing informal financial intermediaries** by lending to them for onlending to their customers. This can be dangerous for the informal financial intermediary, however, because it could disrupt the equilibrium that makes the institution more efficient.

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Mr. E. Lule, Deputy Governor of the Bank of Namibia, spoke about the difficulty of providing rural finance to black farmers in Namibia. Blacks make up a significant percentage of the population of Namibia and, in general, do not have individual title to communally held lands. Moreover, because black farmers are situated in what was the former war zone, banks are reluctant to open branch offices for providing financial services. White farmers, by contrast, not only hold title to their lands, but also farm great expanses of prime agricultural land. They borrow at low interest rates (3% fixed) and sell their products to South Africa and Europe. The type of financing available to large agribusiness concerns controlled by whites is significantly different from the type which is available to black communal farmers. Given this background, Mr. Lule emphasized that one of the principal challenges of Namibia's nascent financial sector is increasing black communal farmers' access to credit.

Mr. Seth Vordzorgbe, USAID Program Economist, pointed out that there are two broad approaches to working with both the formal and informal financial sectors. One approach is to improve the informal financial system through training. Another way is to establish linkages with the formal system, for example, by opening cooperative bank branches in a major city.

Dr. Viganó responded by making a number of observations. Among them were:

- development banks should adopt means of evaluating creditworthiness similar to those in use in the informal sector;
- the size of the intermediary group should be small enough so that peer/community pressure remains an important consideration in loan repayment;
- government supervision of the informal financial sector occurs when the village money keeper deposits the pooled savings of his fellow villagers in a commercial bank;
- linkages between the formal and informal financial sector can benefit the economy. However, they should not be forced to the detriment of both the sectors.

Dr. Maruping concluded the discussion on informal financial markets by saying that the informal financial sector is very important in economic development and should not be neglected. In his own research, Dr. Maruping found that the poor have a higher repayment rate and take borrowing very seriously.

2.8 Emerging Financial Markets in Southern Africa

This session was an important opportunity for the audience to benefit from Dr. Maruping's insight into the development of financial markets in Lesotho and the region.

Dr. Maruping provided some historical background on the informal, semiformal, and formal financial markets in Lesotho. Traditionally, the wealth is held in livestock. Loans are repaid in terms of livestock, which explains why the Sesotho word for interest means "offspring." With the monetization of the economy, borrowing and lending took place between friends, with no interest and collateral. Methods of mobilizing financial resources such as *Stokoefele* (Informal Savings and Loan Club) allocated the pooled resources to each of its members in turn. Dr. Maruping strongly believes that the resources of *Burial Societies*, gathered for very specific purposes, can be transformed into productive financial resources.

Semiformal institutions include cooperative societies, credit unions and trade groups. In Lesotho, cooperative societies have become tainted by fraud, corruption and mismanagement and have consequently lost public confidence. On the other hand, Cooperative Credit Unions which were established in the late 1950s, had 30,000 members by 1988. However, they became the conduit for targeted credit schemes which were not to their long term benefit. The conditions imposed by these credit schemes were inconsistent with the aims of the credit unions. Leasing and Hire-Purchase companies exist usually through the help of South African companies. Money lending on a commercial scale is relatively new and has arisen due to tight credit controls.

The South African Postal Savings Bank, established in what was once *Basotholand*, was the first formal financial sector institution in Southern Africa. Today, the formal financial institutions include the Lesotho Bank, Barclays, Standard Chartered, the Lesotho Agriculture Development Bank, the Lesotho Building Finance Company and the Lesotho National Development Company. The Lesotho National Insurance Company, IGI, Metropolitan Life and other insurance brokers also have offices there.

A salient characteristic of Lesotho's financial markets is excess liquidity. Dr. Maruping listed six possible causes:

- tight money policy;
- highly segmented markets;
- limited range of financial products;
- few bankable projects;
- high default rate;

- poor judicial system.

In Dr. Maruping's opinion, there are six important items on the agenda for financial market development in Lesotho:

1. New financial institutions, such as the stock market, need to be established to develop the capital markets. The Lesotho Investment Holdings Corporation is an important vehicle for mobilizing capital.

2. New instruments are needed to help develop a secondary market. This would improve the effectiveness of open market operations.

3. Commercial banks need to provide new services and a wider range of products.

4. Funds migrating to the RSA should be diverted to productive use in Lesotho.

5. Legitimate informal financial and semiformal institutions should be assisted.

6. Monetary union within the PTA (Preferential Trade Arrangement) should be the ultimate goal of regional integration in financial markets. Member countries of the PTA should merge their Central Banks into one Central Bank with one governor for the entire PTA.

3. CONCLUSIONS

In the final panel, each of the major participants in seminar offered his/her conclusions.

Mr. Seth Vordzorgbe suggested:

- The Central Bank needs to play a stronger role in coordinating credit schemes of various donors. Frequently, these schemes are at cross purposes.

- Developing a unit trust would encourage domestic investment and increase the efficiency of state-owned enterprises until such time when privatization becomes practical.

Mr. P. Kotelo, the Assistant General Manager of the Lesotho Bank, offered his conclusions:

- To remedy the problems which bankers encounter in identifying bankable projects, import substitution activities should be pursued to increase the number of investment opportunities in Lesotho.

Governor Maruping noted that he is reviewing proposals on:

- strengthening the supervisory role of the Central Bank (although he prefers self-regulation);

- reviewing legislation governing the financial system;

- moving toward indirect monetary policy instruments;

- improving the legal system;

- establishing a stock exchange to facilitate the privatization process. The stock exchange would be very simple such as a small office where brokers could meet;

- establishing a unit trust that would ensure wide participation;

- gaining access to targeted credit programs with rates close to commercial (market) rates;

- improving extension services by providing them with more information regarding government lending and assistance programs;

- strengthening information systems and accounting standards.

Before thanking the participants and sponsors, Dr. Maruping concluded by speaking about donor sponsored targeted credit schemes. He said that it is important to carefully choose an institution to build capacity, one that would not be deterred from achieving its aims and objectives. He said that credit schemes can undermine local institutions but can be useful in helping open areas considered too risky or unprofitable by the formal sector.

The seminar was officially closed by the United States Ambassador to the Kingdom of Lesotho, **Mr. Leonard H.O. Spearman, Senior.**

4. RESULTS OF QUESTIONNAIRE

The following are the results of a questionnaire on the future directions for Lesotho distributed to the participants at the Financial Markets Seminar held from May 25th to 27th, 1992 in Maseru, Lesotho. Participants were asked to rank by order of importance the three most important actions which should be pursued after the seminar. Please note that these responses indicate the personal opinion of the respondents and do not necessarily represent the official positions of A.I.D. sponsoring organizations or a consensus opinion of the seminar as a whole. Grouped according to a common topic (as much as possible), these comments have not been altered in any way.

MOST IMPORTANT

- Improve performance of the banking sector.
- Encourage Basotho people to save their money regularly with the banks.
- Educate the public and top government officials on the importance of financial markets in the economic development of the country.
- Broaden the branch and agency network of local banks to mobilize savings of the rural community and introduce other schemes of credit to depositors and borrowers.
- Decentralize the commercial banks into rural areas and facilitate competition among them.
- Modify home markets: non-formal, formal and semi-formal.
- Harness informal sector savings.
- Facilitate the Informal sector-not only through credit, rather research on what kind of assistance is necessary. Therefore, first research on why credit unions failed, then follow up action necessary can be determined from this. Also, strengthen the Central banks supervisory capability.
- Review the legislation in order to make financial markets function in a more productive manner.
- Improve the legal system, with a view towards speeding the legal processes against defaulters.
- Extend the range of financial instruments.

- Allow the Central Bank of Lesotho (CBL) to proceed with the sale of Treasury-bills and attendant education to the public.
- Introduce/strengthen government securities with a view towards opening financial markets and utilizing/regulating excess liquidity.
- Identify target groups that will be involved in the financial markets.
- Accelerate commercialization of SOEs to increase private sector participation in the economy.
- Encourage privatization of SOEs.
- Macroeconomic policy and financial markets.
- Establish a stock exchange.
- Form a Unit Trust.
- Look into need of continued alliance of the loti with the rand as a policy issue.
- Establish an import-substitution financing scheme.

SECOND MOST IMPORTANT

- Look at rural economies and access a possibility of how best to provide a service there.
- Improve productive economic growth, especially in the informal sector.
- Encourage credit unions and cooperative societies. They form an important informal sector of our economy. Give them assistance but leave them informal as much as possible.
- Revive credit unions and incorporate them into the formal financial sector.
- Use donor aid to strengthen credit union schemes. Also use aid to educate members in management and accountability of funds.
- Make the environment conducive for internationalization and liberalization of banking and other financial markets.
- Educate the community about new instruments.
- Continue communication/information with/to all active players/participants in the financial markets.
- Banks, T-bills.
- Continue with the development of the money market that has just been introduced.
- Promote financial markets competition by including more financial institutions.
- Maintain regional influence on local financial markets.
- Central Bank of Lesotho (CBL) to address closely the question of increasing competition in the formal financial sector.
- CBL to promote competition among financial intermediaries, by allowing new entrants into the market.
- Encourage external markets to invest in Lesotho in order to create competition.
- Privatize the economy to improve opportunities for private sector participation.
- Stock exchange should be promoted.

- Establish a holding investment company.
- CBL should address itself to control outflow of funds through Pension funds and Insurance schemes.
- Establish marketing intelligence to serve as a link between CBL, the banks and the groups.
- Develop the mechanism for Unit Trust as soon as possible.

THIRD MOST IMPORTANT

- Informal sector: organizations dealing with the informal sector.
- Informal and semi-formal financial sector to be assisted to perform better; expertise is needed here.
- Register all informal financial institutions, both in the rural and urban areas.
- Stokoefele, Matsema, Lo amohelisana (informal savings and loans clubs) should be encouraged within our working community. These are traditional and easily understood.
- Look at a range of instruments available and assess how best to improve/increase them.
- Introduce T-bills/T-bonds to the public but educate the public about them first.
- Licensing of more banks to bring about competition in banking services.
- Recommend that the government commercializes/privatizes SOEs. This will lead to the emergence of capital markets.
- Open up a venue of raising capital funds for financing equity in private company.
- Decide on launching Lesotho Investment as soon as possible with the idea of developing venture capital.
- Find ways of re-investing insurance income, etc., in the economy.
- Establish institutional structures for their efficient implementation.
- Draw up action plan for implementation of all the contributors given in these seminar.
- Correct loopholes in policies.
- Re-examine the aims and objectives of the ESAF (by evaluating the results) in order to achieve a continuous assessment of progress in this direction.
- Strengthen extension services.
- Targeted credit schemes.
- Promote targeted credit schemes at market rates.

MOST IMPORTANT COMMENTS

- Extend the range of financial instruments at both the Central Bank and Commercial Banks within a year's time.

- Selling T-bills to the public is the most important step and should be implemented in 1992. It will introduce the public to saleable financial products, and uses a riskfree instrument which will help to build confidence of the public in the market.

- The most important thing to enter into the productive sector is the financial constraint which could be eased through the establishment of a local money market. The establishment of a stock exchange should be instituted together with education, training and information flow to the public, especially the private sector, as soon as possible.

- Support the organizations engaged in training of small-scale entrepreneurs, specifically training of manpower.

- Reorient the work force by training. Provide resources where necessary and work towards self-financing.

- Financial intermediaries must be strengthened in terms of training their personnel and indigenous entrepreneurs, particularly in the informal sector. Indigenous entrepreneurs need to be trained in terms of harnessing the available facilities in the financial markets.

- Train bank staff. Need to improve analytical capacity of the Central Bank. Need an integrating framework or policy formulation.

- Decentralization of the commercial banks will improve the financial network throughout the country and promote households' savings while at the same time improving the infrastructure in the country. Allowing new financial institutions in the country will promote competition and hence, efficiency. These should be done immediately.

- Recommend that government re-activate Lesotho Investment Holdings (LIH): it should be taken out of the armpit of the LNDC. It should be made to operate autonomously. For now, people do not see it as an Investment company, also, LNDC does not give the publicity it (LIH) requires because it has its hands full.

- There should be more effort in mobilizing savings of the rural community and devising means of extending credit to them. Since Post Offices are spread throughout the country, commercial banks can work in collaboration with them in order to extend services to the rural community.

- Basotho people, especially those in the rural areas, keep their money in their homes and not in banks, denying the economy access to and the usefulness of that money, including themselves. Education of the rural community via existing entrepreneurial training (informal) institutions should be done immediately.

- Revitalize credit unions, by educating the participants there in and thereafter making them targeted credit schemes. They are most important because the infrastructure already exists for their operation in a greater extent than anything else in the informal sector. Thus they can be the most viable savings as well as productive vehicles in this sector.

- Try and mobilize savings and deposits. Start by stopping outflow of funds through servicing funds with externally based companies. For example: pension funds and insurance companies.

- It is difficult to single out an important step of this stage. My feeling is that the entire economic performance should be addressed because whatever efforts which might be undertaken now may fail because of other factors. But at least towards the end of the year or beginning next year, the idea of selling the stock exchange could be started. This could follow well after the sale of Treasury bills and bonds to the public.

- The best step is the improvement of the macroeconomic policy, especially in relation to regional influence. It could be achieved mainly by strengthening and implementing the positive recommendation and should be implemented as soon as possible.

- Destroy corruption. The first step to be taken is to start with the public sector as it is the largest and the worst known sector in Lesotho. If this is done, other sectors would follow suit. The sooner this is done, the better. We will have a more prosperous Lesotho.

- For a long time, the rand has served us well to peg the loti against. It does seem to be in problems now and is pulling our economy down. I am not able to assess the situation of our economy to suggest positive solutions, but it does seem necessary to review our position in this respect. It does seem there is need to commission a study of this subject and proceed from results gotten.

- Prioritize the recommendations and contributions given. Form a working committee within 3 months.

- It is very important that an import substitution financing scheme is established immediately. This would help in establishing an industrial base for the country.

APPENDIX A

QUESTIONNAIRE

BLANK QUESTIONNAIRE

FINANCIAL MARKETS SEMINAR
MAY 25th, 26th and 27th, 1992
CENTRAL BANK OF LESOTHO

FUTURE DIRECTIONS FOR LESOTHO

FINANCIAL MARKET DEVELOPMENT

INSTRUCTIONS: After today's presentations on new avenues open to Lesotho's financial markets, please list the three most important actions which, in your opinion, should be followed-up after the seminar. Please return this form to the reception table before lunch. The results will be tallied and included in the **Official Conference Proceedings**.

MOST IMPORTANT

SECOND IN IMPORTANCE

THIRD IN IMPORTANCE

PLEASE COMMENT ON THE SINGLE MOST IMPORTANT STEP WHICH SHOULD BE TAKEN. HOW SHOULD THIS STEP BE IMPLEMENTED? WHEN SHOULD THIS STEP BE TAKEN?

OTHER COMMENTS OR SUGGESTIONS

APPENDIX B

AGENDA

FINANCIAL MARKETS SEMINAR
MAY 25th, 26th and 27th, 1992
CENTRAL BANK OF LESOTHO

MAY 25th

08h00-08h45	Registration
09h00-10h00	Official Opening: Honourable Minister of Trade & Industry
10h00-10h15	Program Outline and Procedures Price Waterhouse Moderator: Jill Minneman
10h15-10h30	COFFEE/TEA BREAK
10h30-11h30	Overview of Financial Markets In this session an overview of financial markets will be given. This will encompass their functioning and elements of their development. Presenter: Dr. Yoon Park, Financial Markets International Research Institute (FMIRI)
11h30-13h00	The Role of Finance in Development The presenter will discuss the key role that finance plays in development and the relationship between the performance of the financial markets and the development of the economy. An example from another African country will be presented. Presenter: Dr Yoon Park, FMIRI.
13h00-14h00	LUNCHEON AT CENTRAL BANK
14h00-15h15	Targeted Credit Schemes Current attempts at addressing the problem of limited facilities for Basotho entrepreneurs will be critically evaluated. The impact of credit schemes will be examined with a view to understanding alternative approaches to bridging the gap between formal and informal finance. Chair: Reserve bank of Zimbabwe. Presenters: Ms. Laura Vigano FinAfrica, Lesotho Bank, BEDCO, USAID and Central Bank of Mozambique.
15h15-15h30	COFFEE/TEA BREAK
15h30-16h30	Discussion Continued

MAY 26th

09h00-10h15	**Regional Influences on Local Financial Markets**
	Lesotho cannot view its financial market in isolation of the broad changes in the region. The discussion will therefore review the relationship between CMA, SADCC, PTA and global markets as well as compatibility of policies and institutional incentives such as tax, monetary policy instruments and regulatory functions. Chair: Central Bank of Mozambique. Presenters: CBL and Bank of Botswana.
10h15-10h30	**COFFEE/TEA BREAK**
10h30-13h00	**Macroeconomic Policy and Financial Markets**
	Lesotho is cooperating with the IMF/The World Bank in the SAF/ESAF- supported structural adjustment programme. This session will review the programme and discuss its relationship to financial markets in Lesotho. Chair: Reserve Bank of Zimbabwe. Presenters: CBL and Dr. Yoon Park.
13h00-14h00	**LUNCHEON AT CENTRAL BANK**
14h00-15h15	**Discussion Continued**
15h15-15h30	**COFFEE/TEA BREAK**
15h30-16h30	**Informal Finance and Rural Development**
	Informal Financial Institutionsand arrangements will be examined in their context as a reflection of a demand for financial services not met by the formal sector. Presenter: Ms. Laura Vigano, FinAfrica.

MAY 27th

09h00-10h15	**Emerging Financial Markets in Southern Africa: Country Cases.**
	During this session new avenues open to Lesotho will be explored. New options will be suggested and critically evaluated. The aim being to identify new services and mechanisms which would hopefully provide alternatives and lead to expansion of the financial system. It will form an exploration of ways of achieving financial deepening in Lesotho. Presenter: CBL, Dr. Maruping.
10h15-10h30	**COFFEE/TEA BREAK**
10h30-12h30	**Discussion Continued**
12h30-13h00	**Ambassador of the U.S. to the Kingdom of Lesotho, Ambassador Spearman.**
13h00-14h00	**LUNCHEON AT CENTRAL BANK**

APPENDIX C

LIST OF PARTICIPANTS

FINANCIAL MARKETS SEMINAR

LIST OF PARTICIPANTS

NAME		ORGANIZATION
1. Mr. J.L. Zwane	-	Ministry of Finance
2. Mrs. T.M. Sekoati	-	LNDC
3. Mrs. M.L. Moiloa	-	Ministry of Finance
4. Mrs. M.S. Lebesa	-	Planning
5. Mr. N.B. Leleka	-	LADB
6. Mr. S.A. Lee	-	Barclays Bank
7. Mr. R.J. Matsoha	-	NUL
8. Mr. R.F. Williams	-	Agric. College
9. Mr. T. Pokane	-	Barclays Bank
10. Mr. P. Nkoe	-	LTC
11. Mr. A. Polisa	-	LMA
12. Mr. S.T. Lesole	-	LOIC
13. Mr. P. Kotelo	-	Lesotho Bank
14. Mr. M. Khiba	-	Business Alliance
15. Ms. Snezana Sazdic	-	UNDP
16. Mrs. K.M. Lichaba	-	LNIC
17. Mr. T.M. Borotho	-	Water Branch
18. Mrs. L. Mokhesi	-	Central Bank
19. Mrs. M.F. Mohasoa	-	Central Bank

20. Mr. L.T. Tuoane - Ministry of Finance

21. Dr. A. Maleiane - Banco de Mocambique

22. Ms. M. Qoane - Trade & Industry

23. Mrs. T.M. Namane - Central Bank

24. Mr. N. Monyane - Lesotho Bank

25. Mr. M.F. Borotho - Central Bank

26. Mr. F.L. Maema - Justice & Prisons

27. Dr. L. Clarke - Bank of Botswana

28. Mr. E. Lule - Bank of Namibia

29. Ms. J. Minneman - Price Waterhouse - Washington

30. Mr. P.M. Makotoane - Ministry of Interior

31. Mrs. M. Mofelehetsi - Central Bank

32. Mr. G.I. Ramotsotso - Standard Bank

33. Mr. F.L. Selialia - Central Bank

34. Mr. M. Ntabeni - Standard Bauk

35. Mr. T. Wolde-Semait - Central Bank

36. Mrs. L. Vigano - FINAFRICA - University of Bergams

37. Dr. Y.S. Park - FMIRI

38. Mr. M. Gardiner - USAID

39. Dr. A.M. Maruping - Central Bank

40. Dr. P.E. Khabele - ITC

41. Ms. P. Lebitsa - Lesotho Flour Mills

42. Mrs. S.L. Kimane - Lerotholi Polytechnic

43. Mr. M. Makhupane - Central Bank

44.	Mr. P. Molapo	-	Central Bank
45.	Mr. C.A. Reintsma	-	USAID
46.	Ms. M. Phate	-	Central Bank
47.	Mrs. A.M. Sepitla	-	USAID
48.	Mr. K. Lekhesa	-	Central Bank
49.	Mr. R.J. Elias	-	Central Bank
50.	Mrs. N. Mashologu	-	Central Bank
51.	Mr. M. Matekane	-	Central Bank
52.	Mr. M.C. Moleko	-	Central Bank
53.	Mr. T. Foulo	-	Central Bank
54.	Mr. G.M. Molise	-	LEC
55.	Mr. P.T. Makae	-	Lesotho Bank
56.	Mr. A.L. Pepenene	-	LCCUL
57.	Mr. M. Petlane	-	Manpower Development
58.	Mr. S.K. Phafane	-	BEDCO
59.	Mr. S. Vordzorgbe	-	USAID
60.	Mrs. K. Mophethe	-	LHDA
61.	Mr. B.I. Ishac	-	Ministry of Finance
62.	Mr. G. Cawley	-	Ministry of Finance
63.	Dr. P.M. Senaoana	-	NUL (Economics)
64.	Mr. K. Mojaje	-	Barclays Bank
65.	Mr. R.H. Fenech	-	Barclays Bank

APPENDIX D

PAPERS DISTRIBUTED

OPENING SPEECH

BY HONOURABLE A.L. THOAHLANE
MINISTER OF FINANCE AND PLANNING

ON THE OCCASION OF A SEMINAR ON

FINANCIAL MARKETS

HELD AT THE CENTRAL BANK OF LESOTHO
25 - 27 MAY 1992

HONOURABLE GOVERNORS OF CENTRAL BANKS

RESOURCE PERSONS FROM ABROAD

BANK EXECUTIVES

DISTINGUISHED GUESTS

LADIES AND GENTLEMEN,

I FEEL GREATLY HONOURED TO HAVE BEEN INVITED TO OFFICIATE AT THE OPENING OF THIS IMPORTANT SEMINAR ON "FINANCIAL MARKETS". FIRST OF ALL, LET ME, ON BEHALF OF THE GOVERNMENT OF LESOTHO, EXTEND A VERY WARM WELCOME TO THE ENTIRE TEAM OF EXTERNAL RESOURCE PERSONS WHO HAVE COME FROM AS FAR AFIELD AS THE UNITED STATES OF AMERICA, ITALY AND FROM SOME OF THE CENTRAL BANKS IN OUR SUB-REGION. THEY ARE HERE TO SHARE WITH US THEIR RICH AND EXTENSIVE EXPERIENCE RELATING TO THE ROLE THAT FINANCIAL MARKETS CAN AND SHOULD PLAY IN GENERALLY FACILITATING ECONOMIC DEVELOPMENT. WE ARE GRATEFUL THAT THEY COULD COME AND WISH THEM A HAPPY AND BENEFICIAL STAY IN OUR MOUNTAIN KINGDOM.

ALLOW ME, MR. CHAIRMAN, TO EXPRESS MY SINCERE CONGRATULATIONS TO THE ORGANISERS OF THIS SEMINAR FOR HAVING FINALLY PUT IT TOGETHER DESPITE SOME HITCHES THAT WERE ENCOUNTERED EARLIER. THEIR

PERSISTENCE HAS NOW BEEN REWARDED. I AM AWARE THAT THIS HAS BEEN A COLLABORATIVE EFFORT BETWEEN THE CENTRAL BANK OF LESOTHO ON THE ONE HAND AND USAID (LESOTHO) ON THE OTHER. I AM ALSO AWARE THAT USAID HAS MADE A SUBSTANTIAL CONTRIBUTION TOWARDS THIS JOINT VENTURE WHICH LESOTHO GOVERNMENT HIGHLY APPRECIATES. THIS, OF COURSE, COMES AS NO SURPRISE TO US; THE UNITED STATES GOVERNMENT HAS BEEN A TRUSTED FRIEND AND PARTNER IN THE DEVELOPMENT EFFORT FOR MANY YEARS.

MR. CHAIRMAN,

LET ME NOW TURN TO THE BROAD SEMINAR SUBJECT OF "FINANCIAL MARKETS" WHICH WILL BE DISCUSSED HERE IN THE NEXT TWO AND A HALF DAYS. THE LEVEL OF DEVELOPMENT OF FINANCIAL MARKETS IN ANY COUNTRY IS CLOSELY RELATED TO THE LEVEL OF ECONOMIC DEVELOPMENT IN THAT COUNTRY. IT IS NOT SURPRISING, THEREFORE, THAT THESE MARKETS ARE RELATIVELY UNDERDEVELOPED IN LESS DEVELOPED COUNTRIES SUCH AS LESOTHO. BECAUSE WE ALL ACKNOWLEDGE THE PIVOTAL ROLE OF EFFICIENT FINANCIAL MARKETS IN THE DEVELOPMENT PROCESS OF OUR ECONOMIES, WE SHOULD AGREE THAT MEASURES THAT ARE AIMED AT THEIR DEVELOPMENT SHOULD FORM AN INTEGRAL COMPONENT OF OUR OVERALL NATIONAL DEVELOPMENT STRATEGIES.

WHILE IT IS CORRECT TO SAY THAT THERE HAS BEEN SOME ENCOURAGING PROGRESS IN RESPECT OF ECONOMIC GROWTH IN LESOTHO IN RECENT YEARS, IT WOULD BE REASONABLE TO SAY THAT PERHAPS MORE PROGRESS COULD HAVE BEEN MADE IF CERTAIN DEFICIENCIES AND IMPERFECTIONS DID NOT EXIST IN OUR FINANCIAL MARKETS. THESE IMPEDIMENTS HAVE TENDED TO MAKE THE MARKETS LESS EFFICIENT IN PERFORMING THEIR PRIMARY ROLE OF FACILITATING THE PROCESS OF TRANSFER OF FUNDS

FROM LENDERS TO BORROWERS, THAT IS FROM SAVERS AND OTHERS WHO HOLD SURPLUS FUNDS TO INVESTORS - BOTH CURRENT AND PROSPECTIVE.

IT IS, THEREFORE, NECESSARY TO TAKE STOCK OF OUR SITUATION AND CLEARLY DETERMINE THE EXISTING DEFICIENCIES AND/OR IMPERFECTIONS SO THAT APPROPRIATE MEASURES CAN BE TAKEN TO REMOVE THEM FROM THE MARKETS.

MR. CHAIRMAN, LADIES AND GENTLEMEN, LET ME PROVOKE YOU BY POSING JUST A FEW QUESTIONS WHICH I WOULD URGE YOU TO CONSIDER AS YOU GO THROUGH YOUR DISCUSSIONS. MANY MORE CAN BE ASKED:

- ARE PRESENT INSTITUTIONAL STRUCTURES ADEQUATE FOR THE PRESENT AND FUTURE DEVELOPMENT OF THIS COUNTRY? IF NOT, HOW AND TO WHAT DEGREE SHOULD THEY BE STRENGTHENED TO BE ABLE TO PERFORM EFFICIENTLY FROM NOW ON?

- DOES THE COUNTRY HAVE ENOUGH INSTITUTIONS TO PLAY THE ROLE OF FINANCIAL INTERMEDIARIES? ARE THESE INSTITUTIONS DOING ENOUGH TO MOBILISE SAVINGS FROM BOTH FORMAL AND INFORMAL SECTORS?

- ARE AVAILABLE INSTRUMENTS AND SERVICES IN THE MARKETS ADEQUATE TO CATER FOR THE NEEDS OF ALL CATEGORIES OF PRESENT AND POTENTIAL PARTICIPANTS IN THE MARKETS?

- WHAT MECHANISMS DO WE HAVE FOR MATCHING THE NEEDS AND REQUIREMENTS OF LENDERS AND BORROWERS OF ALL CATEGORIES?

THE ANSWERS TO THESE QUESTIONS AND OTHERS WILL, TO MY MIND, BE BOTH INTERESTING AND REVEALING. MORE IMPORTANTLY, THEY WILL CONSTITUTE A VITAL INPUT INTO THE SUBSEQUENT EXERCISE THAT LOCAL PRACTITIONERS AND EXPERTS WILL CARRY OUT IN PREPARATION FOR POSSIBLE RESTRUCTURING AND DEEPENING OF THE FINANCIAL SYSTEM IN LESOTHO.

AMONG OTHER THINGS, THE EXERCISE SHOULD AIM AT IMPROVING ACCESS TO THESE MARKETS. IN THIS REGARD COMMUNICATION IS VERY IMPORTANT. RELEVANT MARKET INFORMATION SHOULD BE WIDELY DISSEMINATED TO ALL SECTIONS OF THE POPULATION. IT WILL ALSO BE VITAL FOR US TO MAINTAIN AND IMPROVE UPON OUR CURRENT MACROECONOMIC POLICIES, NOTABLY MONETARY POLICY THAT WILL BE CONDUCIVE TO THE DEVELOPMENT OF THESE MARKETS. THESE POLICIES, TOGETHER WITH PERTINENT LEGAL AND REGULATORY MEASURES, WILL CREATE AN ENVIRONMENT FOR BUILDING A FINANCIAL SYSTEM THAT WILL BE MORE RESPONSIVE TO THE NEEDS OF LENDERS AND BORROWERS.

IN RECOGNITION OF THE FACT THAT SELF APPRAISAL MAY NOT ALWAYS BE OBJECTIVE, THE ORGANISERS OF THIS SEMINAR CONSIDERED IT ADVISABLE TO INVITE RESOURCE PERSONS FROM OUTSIDE THE COUNTRY. THESE ARE PEOPLE WITH VAST KNOWLEDGE AND EXPERIENCE IN THE FIELD OF FINANCIAL MARKETS. WE, THEREFORE, EAGERLY LOOK FORWARD TO BENEFITTING FROM THEIR EXPERTISE NOT ONLY WITH REGARD TO THE APPROACHES THAT THEY HAVE FOUND APPROPRIATE FOR DEVELOPMENT OF EFFICIENT FINANCIAL MARKETS IN ECONOMIES OF OUR TYPE AND LEVEL OF DEVELOPMENT, BUT ALSO IN RESPECT OF ANY PITFALLS THAT WE MAY HAVE TO AVOID TO ENSURE CONTINUED SMOOTH FUNCTIONING OF THE MARKETS.

THERE ARE OTHER BENEFITS THAT WOULD ACCRUE FROM SMOOTHLY AND EFFICIENTLY OPERATING FINANCIAL MARKETS. I NEED NOT ENUMERATE THEM AT THIS JUNCTURE. I AM CONFIDENT THAT THEY WILL BE DISCUSSED DURING THE SEMINAR.

MR. CHAIRMAN, LADIES AND GENTLEMEN, I AM AWARE THAT YOU HAVE A WIDE RANGE OF TOPICAL ISSUES TO DISCUSS IN THIS AREA OF FINANCIAL MARKETS AND HOPE THAT ALL OF YOU WILL FEEL RICHLY REWARDED AT THE END OF THE SEMINAR.

IT IS MY HONOUR AND PRIVILEGE TO NOW DECLARE THIS SEMINAR OFFICIALLY OPENED.

FINANCIAL MARKET DEVELOPMENT IN DEVELOPING COUNTRIES

Paper Presented at the Financial Market Seminar
Central Bank of Lesotho, Maseru, Lesotho
May 25 - 27, 1992

Prof. Yoon S. Park
George Washington University
Washington, D.C.

Role of Finance in Economic Development

After a century-long debate about the neutrality of finance to economic activities, current economic theories seem to accept widely that the financial sector does affect the real economy. In modern financial theories and texts, the early monetarists' view of financial sector neutrality has become history. Current topics in this area do not relate to whether finance affects economic activities but concern how finance affects the economy and the relationship between financial development and real development.

Monetarists before the Great Depression in the early 1930s thought that the real sector of the economy was largely neutral to the supply of money and financial market activities. The traditional quantity theory of money states that the level of money only affects the price level and nominal wages, with little impact on the economy's output and employment levels. These theories believed that the monetary sector played an extremely passive role in economic development at best.

The Great Depression was an important occasion for many economists, represented mainly by John Maynard Keynes and his followers, to reassess the effect of the monetary sector on the real sector. Keynes argued that the monetary sector affects the general equilibrium of the economy by setting interest rates which in turn determine the level of real investment. He wrote,

> "It seems that the rate of interest on money plays a peculiar part in setting a limit to the level of employment, since it sets a standard to which the marginal efficiency of capital asset must attain if it is to be newly produced."[1]

He also thought that the public exhibits so-called "money illusion," which makes it difficult for the monetary sector to be neutral in its impact on the real sector. During the 1950s, the traditional monetarist view of finance was almost totally replaced by that of the fiscalists, who followed the Keynesian view of finance.

During the 1960s several economists, including James Tobin,

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[1]John Maynard Keynes, The General Theory of Employment, Inflation and Money, MacMillan & Co., London, 1936.

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Harry Johnson, Miguel Sidrauski, David Levhari and Don Patinkin, attempted to examine the implications of additional monetary holdings on economic growth. They assumed that, if monetary assets are treated as part of their households' wealth, under certain conditions their savings objectives will be satisfied by holding more monetary assets and less physical capital, thus slowing real economic growth. Inflation, being a tax on monetary assets, would discourage holdings of monetary assets and encourage the accumulation of physical capital thus stimulating faster economic growth. The aggressive expansionary fiscal policy in many countries in the 1950s and 1960s received theoretical backup from this view.

In the early 1970s, a rethinking of the relationship between finance and economic development emerged after bitter experiences of stagflation in many countries. Some economists, represented by Ronald McKinnon and Edward Shaw, began to think that unduly expansionary monetary and fiscal policies were detrimental, not beneficial, to the accumulation of physical capital and economic growth. These economic theorists, with knowledge of actual country experiences, argued that a distorted and repressed financial sector could intercept and destroy impulses to economic development while a sound financial sector would accelerate economic growth. They argued that the Keynesian and neoclassical theories and policies assume a well-functioning financial sector, but had not worked well in developing countries where financial markets were underdeveloped and imperfect. New models were proposed to indicate the conditions under which "financial deepening" would be a complement to, not a substitute for, the accumulation of physical capital. Financial deepening would lead to a more efficient allocation of capital by shifting more of the available resources to those with better investment opportunities and returns.

Ronald I. McKinnon proposed a model in which, assuming investments are usually lumpy and indivisible, an appropriately sized monetary system, represented mainly by cash holdings of the public, would maximize economic growth and preventing monetary accumulation from becoming a substitute for physical capital accumulation, because money and physical capital are complementary. He explained that the real deposit rate of interest affects saving, investment and growth on the assumptions that: (a) all economic units are confined to self-finance; and (b) indivisibility in investment is significant so that potential investors must accumulate money balances prior to their investment.

Edward S. Shaw's model viewed the overall financial system, rather than the narrow monetary system examined by McKinnon, as more relevant in understanding the relationship between finance and economic development. Shaw thought that the services produced in the financial sector are important inputs in producing economic output. He maintained that expanded financial intermediation between savers and investors resulting from financial liberalization, i.e., higher real institutional interest rates, increases incentives to save and invest and raises the average efficiency of investment. Financial intermediaries raise real returns to savers and, at the same time, lower real costs to investors by accommodating liquidity preference, reducing risks through diversification, reaping economies of scale in lending, increasing operational efficiency and lowering information costs to both savers and investors through specialization and division of labor. Financial intermediation is repressed and suboptimal when interest rates are administratively fixed below their equilibrium levels. Like McKinnon, Shaw advocates financial liberalization, including deregulation of interest rates and functions of various financial institutions, as a process of financial deepening.

Financial structuralists, represented by Raymond W. Goldsmith, emphasize the institutional aspect of financial development as a key element of financial deepening. They are primarily concerned with the growth of financial systems that historically accompanies real economic growth. Financial deepening of an economy is achieved as the consequence of financial development, which Goldsmith defines as "sophistication of the structure of the financial sector." Financial development takes place with the introduction of increasingly diverse financial instruments to savers issued, and traded by increasingly diverse financial institutions, with diversified patterns of ownership and within the framework of regulations on the behavior of financial institutions and markets. He also argues that financial development for every economy is initiated by exploitation of an appropriate saving-investment technology that is selected for historical, social, political and economic reasons. As any technology becomes outmoded and its translation into economic return over time, financial development accompanies technology optimization by experimenting with alternative technologies.

Modern economists and the economic policy authorities of developing countries (DCs) widely accept the notion that the financial sector contributes to economic development through various positive economic functions, in particular, promotion of resource mobilization, and that financial deepening with a wide range of financial instruments and institutions will accelerate economic development in DCs. However, several economists have voiced cautions on the danger of financial liberalization in DCs without consideration of endogenous constraints existing in the financial system. While elimination of interest rate ceilings and promotion of competition in the financial market are important to increasing the efficiency of financial intermediation, market imperfections make it difficult for many DCs to tap fully the benefit of financial liberalization. These imperfections arise from intrinsic constraints on credit markets, such as information costs, oligopolistic and cartelized banking systems, the costs of assessing the credit risks of customers and the resulting information constraints, and the absence of an equity market which can complement the credit market to finance risky investments. These constraints could continue to be a significant barrier to efficient credit allocation even when legal and institutional constraints, such as interest rate ceilings, are eliminated. In particular, the relationship between imperfect information and credit rationing in competitive credit markets and the resulting inefficiencies in credit allocation has been pointed out by several authors.

Role of the Financial Market in Economic Development

Most academicians and policy makers in DCs hold the view that financial market development is a key element of financial deepening as this market provides a variety of financial assets to the economy to facilitate resource mobilization for investment. Arguments against the benefits of financial market development are hardly heard. Financial market development is often regarded as an important barometer of financial deepening in DCs where financial sectors are represented mainly by the banking industry. The importance of financial market development to financial development and deepening is sometimes emphasized to the extent that it is regarded as a necessary condition for complete financial liberalization. Despite the general perception that financial market development is an evolutionary process correlated with the level of per capita income, the question as to why one country with lower per capita income may have a much more advanced securities market than a higher income country has not been answered satisfactorily yet.

Van Agtmael summarizes and provides a wide range of arguments for the positive role of the financial market in economic development. The financial market could: (i) raise funds for investment through issuance of new securities; (ii) improve efficiency and solvency of the financial system by increased competition in the system and improved financial structure; (iii) facilitate mobilization of financial savings by providing an incentive to save and invest and compete with other financial assets; (iv) improve allocative efficiency of investment by reducing the distortion of planned allocation of resources, which is often plagued with political favoritism, special privileges of the public sector over the private initiative, a preference for large projects over small businesses, credit rationing and distorted interest rates; (v) enhance solvency of the corporate sector by strengthening the financial structure of corporations; (vi) assist deconcentration of ownership by promoting the spread of ownership participation by the general public; (vii) expand access for new and emerging companies to venture capital; and (viii) improve accounting and auditing procedures and standards through disclosure of regular, adequate and reliable information, checked by independent auditors.

David Gill and Peter Tropper argue that major benefits of a strong, healthy equity market in economic development come in, among others, five main ways. First, it contributes to the stability of a country's financial system and economy to the extent that it reduces the vulnerability of companies to floating and high real interest rates through permanent equity financing. Secondly, it helps promote growth and employment by providing finance for small businesses both directly through a country's larger formal markets, and indirectly by making venture-capital operations more feasible in the more advanced developing countries. Thirdly, it evertually promotes democratic ownership of industry by distributing the ownership of securities more widely among the public. Fourthly, it can make access to international capital markets easier to the extent that the market develops into an efficient and liquid securities exchange. Lastly, a formal and well regulated market increases economic efficiency by establishing fair prices for securities and by minimizing the cost of buying and selling them.

Building Efficient Financial Markets

There are a host of essential measures required to ptomote the development of efficient financial markets in DCs. Some of the important ones are discussed in this section.

A. Restructuring

To develop financial markets that can in the future finance their private sectors efficiently, countries need to undertake a variety of reforms. First, the financial institutions need to be restored to viability. This means stopping the accrual of unpaid interest, eliminating rollovers and refinancing of nonperforming loans and making provisions forbad debts. Institutions that then have no capital must be recapitalized, merged with healthy institutions, or closed if they have no further role to play in the financial system. As the losses will in many cases exceed the equity of the institution, losses will have to be absorbed either by the creditors of the institutions--who in most cases are the depositors--or by the governments (that is, by the taxpayers).

B. Financial Infrastructure

Countries must build their financial infrastructure. Under infrastructure, we may include three things: information systems, legal systems, and regulatory systems. Financial institutions and markets should make choices among investments to be funded on the basis of expected return and risk. Good information is needed in order to make those choices, to monitor firms' behavior after funding, and to take appropriate corrective action if it appears that things are not going as planned. For all three reasons, financial institutions require reliable company data, which in turn depends upon better accounting, auditing and rules on disclosure of financial information.

Also, there must be adequate legal protection for both debtors and creditors. In some countries, the company law, the banking and securities laws, and the bankruptcy law are all outmoded or weakly enforced. Rights and responsibilities under financial contracts must be clearly spelled out and enforced. No one considers foreclosure a desirable outcome, but it is the threat of foreclosure that keeps people from willfully defaulting, and it is knowing that debtors will not willfully default that encourages institutions to lend in the first place. Financial agreements are legal contracts and for finance to flourish, there must be an adequate legal basis for drafting and enforcing these contracts.

The third item under infrastructure in the system of prudential regulation and supervision. Financial institutions have a high degree of leverage: most of the money loaned by financial intermediaries belongs to others, not to the owners of the institutions. Typically, in a commercial bank there are $19 in deposits to each one dollar in capital. To profit from the high leverage, owners and managers of such institutions have an incentive to manage the institution in a highly risky or even fraudulent manner. A recent study by the U.S. Comptroller of the Currency found that fraud and mismanagement were involved in 90% of the bank failures in the United States. Relatively small losses in the loan portfolio--in the case of commercial bank examples cited above, losses of 5%--would jeopardize the institution's ability to pay depositors. In most developing countries bank supervision has focussed on the implementation of economic directives such as credit allocation, to be certain that bank lending was in compliance with government directives. Very little attention has been paid to prudential supervision, that is, the quality of the loan portfolio, the adequacy of capital and the soundness of bank management. The huge losses now found in the banks' portfolio in man y developing countries are testimony to the poor quality of this oversight function.

C. The Policy Environment

Only with a sound policy environment can a financial market develop to its full extent. Some of the important policies are directly financial--such as interest rate and credit control policies--but financial markets are also dependent on macro policy, on exchange rates, and on other policies that affect relative prices. Inflation is a tax on those who hold money and certain other financial assets. As holding these assets is voluntary, the public usually chooses to hold a smaller real stock as inflation rises, reducing the tax but also reducing the size of the financial system. The extent of term finance declines even more rapidly in an inflationary environment. In a country with an overvalued exchange rate, there is capital flight and excessive foreign borrowing. And when the overvaluation is corrected, those with liabilities denominated in foreign exchange suffer large losses. In many countries, we, in the World Bank, find that borrowers, having had trouble in the past, are now unwilling to take loans which carry foreign exchange risk. Any substantial change in relative prices will cause difficulties for financial institutions, for the firms for whom the change in price is unfavorable will be unable to pay their debts. Price reform is now causing serious portfolio problems for banks in the socialist economies. The experience of the 1980s in country after country has made clear the fragility of the financial system in the face of macro economic and price instability.

Most developing countries are today rather open in the sense that the more sophisticated investors--who hold a large part of the financial wealth--can either hold domestic or foreign assets and borrow in domestic or foreign markets. If the rate of return which can be earned on domestic assets is below what can be earned on foreign assets, investors can move a large part of their assets abroad, regardless of whether or not there are capital controls. Those who are unable to move assets abroad will invest in real assets--housing, for example--if the rate of interest paid on deposits is less than the rate of inflation. To build the financial systems the interest rate paid must be in line with expected inflation and the rate that can be earned abroad. In recent years real interest rates in developing countries have been rising and now are an average roughly equal to the rate of inflation, but in many countries rates are still below those in developed countries. Furthermore, there continues to be a considerable amount of directed credit available on very concessional terms.

D. Institutional Development

Turning now to institutional development, the need for governments to intervene to resolve the problems of distressed financial institutions provides a unique opportunity for them to rethink the structure of their financial markets. What financial services and what instruments will countries need during the 1990s? Each country must decide whether the existing institutions will provide these services. Those troubled institutions, which are no longer relevant, can be closed rather than recapitalized.

Financial systems in developing countries are today dominated by their banking systems, which in most developing countries hold at least 80% of the assets of all financial intermediaries. In many countries, the markets are controlled by a few, large, and often inefficient banks. Their size is based, not on economies of scale, but on restrictions on new bank licenses, on interest rate and credit controls that discourage competition, on forced branching, etc. With regard to the costs of intermediation, in inflationary countries and in some of the development banks serving small borrowers, the spread needed to cover the difference between the cost of funds and the lending rate can be as high as 10% of earning assets rather than the 2-3% in developed countries. Large spreads force up the cost of borrowing and discourage investment.

There are a number of ways in which costs can be reduced: policy changes, improved operations and greater competition. Greater freedom for banks to set interest rates, choose their own customers, determine the location of branches, etc., can reduce costs. Competition can be increased by allowing the entry of new banks, by encouraging the development of non-bank financial institutions (NBFIs) and capital markets, and by allowing international trade in financial services.

Poor management has contributed to banks' difficulties. Excessive branching and staffing, poor asset and liability management, and inexact accounting and management information systems have all been a source of weakness. Financial institutions in developing countries are plagued by portfolio problems, which in many cases are the result of poor management. Lending to insiders, excessive concentration of lending in one geographic area or in one industry have been important sources of trouble.

Building NBFIs and capital markets as alternatives to banks will increase competition and efficiency and provide for more extensive services. Let me give just one example. There has been concern in the development community about the shortage of term finance for investment. To meet the need for term finance, the countries supported by the international agencies promoted development finance institutions. But there are other possible sources of term money. In most developed countries contractual savings institutions--life insurance, pension programs, etc.--are the major source of term finance. With the changes now taking place in demographics and living conditions, developing countries also have an opportunity to develop these sources of term finance.

E. Financial Reform

During the 1980s, many countries introduced financial reforms. In perhaps a dozen countries, interest rates were fully liberalized; in many more, while rates continued to be set by government, there was an attempt to keep rates from falling below the rate of inflation. In addition, many countries have curtailed--though few have eliminated--directed credit programs. Competition has been promoted by granting new charters and opening the market to foreign competition and competition from non-bank financial institutions. The centrally planned economies have also made significant reforms in their financial sectors.

What are the lessons to be learned from the experience? Not all the reform programs have been successful and in some cases the governments had to reintroduce the controls they had removed. In the Southern Cone--in Chile, Argentina, and Uruguay--liberalization in the 1970s led to disarray. The reforms were very broad-based and were introduced together with sweeping stabilization programs. It is hard to disentangle the failure of the stabilization measures and the financial reforms. But the lesson is clear that financial reforms are not a substitute for macro economic or price reforms and financial reforms will not succeed unless accompanied by a high degree of economic stability. Furthermore, with a distorted price system, liberalization can lead to resource misallocation first, and then debt servicing problems when price distortions are corrected. Furthermore, liberalization must be accompanied by restructuring of insolvent banks and by the introduction of an adequate system of prudential regulation and supervision. Care must be taken to avoid destabilizing capital flows by not opening the capital account until there is considerable macroeconomic stability.

That makes financial reform sound difficult. But it has been quite successful where it was introduced in Asia--in Korea, Indonesia, and Thailand--and when it was reintroduced in Chile. In the Asian countries there was some, but not substantial, macro instability and price distortions; furthermore, the reform measures were introduced gradually. To conclude, countries that wish to rely more on the private sector need strong financial markets. For that, confidence is needed that contracts will be honored and real values will not be eaten away by inflation. Getting interest rates right is important, but must be complemented by the restructuring of bankrupt institutions, by the institution of adequate accounting and legal systems, by appropriate regulation, and by building the human skills needed for managing complex financial operations.

THE RURAL DEMAND FOR FINANCIAL SERVICES, THE RESPONSE OF THE INFORMAL FINANCIAL MARKET AND THE INTERVENTION OF CREDIT PROJECTS. CRITICAL EVALUATION

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1 CREDIT RISK IN AFRICAN RURAL AREAS

1.1 ECONOMIC CHARACTERISTICS OF AFRICAN RURAL CUSTOMERS

The typical economic units of African rural areas are represented by small-size enterprises, mainly agricultural, where labor force comes from family members. Very often, other collateral activies are run together with agricultural production.

Production techniques and the organization of the production process reflect traditional schemes, and there is often a certain aversion towards the introduction of innovation[1].

As concerns financial management, money and finance may have a variable importance in the life of the enterprise, depending on the degree of monetization of the economy. In some cases, loans in kind are more used that monetary loans. The former may be represented by an offer of services at a certain time of the year returned later by the first receiver.

Debt is often considered a last resort resource, since it is mainly used for emergency purposes, for lack of liquidity and for short-term operations. Peasants are usually averse to very long-run debts, due to the difficulties to forecast the future economic conditions of their enterprises[2].

Forecasts in rural areas are actually difficult because of the high uncertainties that characterize these sectors. Revenues are, in fact, low and very variable for several reasons.

Besides the low level of technology utilized that affects the level of productivity, there is often a lack of basic infrastructures (i.e. communication, irrigations, pricing system) that prevents firms from totally exploiting their productive capacity or from transforming production into revenues.

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[1]The forced introduction of innovative production techniques, sometimes promoted by development projects and supported by a credit scheme have often resulted in a complete failure due to a mismatching between the attitude of peasants and the aim of the project.

[2]These results are confirmed by a research carried out in Ghana. See Bentil, Gadway, Hüttenrauch, Mönikes and Schmidt, Rural Finance in Ghana.

Revenue variability is also a consequence of weather conditions - difficult to control with low-level technology - and international pricing of export goods, where LDC's usually have a very limited contractual power.

1.2 RISK INVOLVED IN LENDING

Given the preceding observations, it is clear that lending to rural customers involves levels of credit risk that may become higher than common levels of risk in other sectors of the economy.

If one accepts the view that creditworthiness is a direct function of the customer's profitability[3], three main factors contribute to the high level of credit risk.

1.
As stated before, actual production and marketing conditions in many countries do not allow for high revenues, revenue stability or steady growth, thus increasing the uncertainty on borrowers' actual repayment ability.

This aspect of credit risk is not under the direct control of the lender and requires that the lender fixes an acceptable risk threshold consistent with its overall objectives. The threshold can be lowered or increased according to the degree of aggressiveness of the lender's marketing strategies, development objectives and portfolio diversification strategies.

2.
In African rural areas another important factor affects the ability to estimate borrowers' repayment capacity on the basis of their profitability.

The typical productive unit being represented by a household-enterprise, there are important financial flows that take place between the productive unit and the household[4].

Personal revenues of family members and revenues from production are often indistinct, as well as current expenses for the enterprise and for the family take

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[3]Creditworthiness, of course, is also strictly linked to the charater (i.e. morality) of the borrower.
[4]These flows are also typical of rural areas of developed countires. Mauri, Profilo fianziario

place contextually. For example, a purchase of food to nourish the family members can be considered both a consumption expense or a productive one, since it implicitly represents part of the salary earned by the labour force.

In such a situation, any computing of periodical financial flows and revenue projections uniquely referred to the enterprise would be misleading, since it is the entirety of the family-enterprise economic unit that should be considered.

Once one agrees on this point, a credit analysis based on the family-enterprise as a whole would not imply relevant difficulties; it would suffice to include in the analysis all the data on profitability, revenues, costs and other important indicators of the global performance of the economic unit under study.

Problems arise, however, because of the lack of information available in this particular context.

3.
An important factor affecting credit risk is the absence of proper information systems whithin the households/enterprises, which would allow a more strict control over customer economic and financial conditions[5].

Within the enterprise, the accountancy system is often absent or insufficient and the degree of precision in book keeping is questionable. In many cases, estimates of production and revenue are not reliable because of the unstability of prices in the markets of products.

It is even harder to correctly measure the relevant variables inherent to the household economic and financial management. Real and financial flows take place in a continous way without being recorded or exactly quantified.

1.3 CONSEQUENCES FOR CREDIT POLICIES

From the preceding observations about the major components of credit risk involved in lending to rural customers it comes out that profitability of rural

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[5]Also this observation applies to agricultural lending in developed economies. See Ruozi, I finanziamenti bancari.

customers is, on average, lower than the other sectors of the economy, more variable and difficult to evaluate.

All these elements of risk are appartently beyond the lender's control. The inability to evaluate the lender's performance, following the principles and methods that the literature on creditworthiness evalutation suggests, may lead lenders to give up any lending activity.

This behaviour, however, implies a loss of revenue opportunities because there might be many customers who are credithworty but who cannot demonstrate it upon classical evaluation methods. Refusing credit to this category of potential borrowers reduces customers' and lenders' income opportunities.

The possible solutions to the problem of rural credit risk management imply a threefold choice for the lender. Given a certain amount of risk inherent in a customer's economic performance, the lender can:

1. not intervene in lending, if the level of risk that the lender wants to bear is lower that the one implied by the financial transaction with rural customers

2. intervene in lending, accepting to lower his credit risk threshold, when the borrower's credit risk is higher than the usual credit risk it accepts

3. elaborate some credit risk control techniques that lower the borrower's credit risk to a level acceptable for the lender.

The conservative approach implied by choice # 1 is followed by those lenders that are not interested in expanding their activities in rural areas, since they already satisfy their economic and financial equilibria operating and expanding their activity in other sectors of the economy. This is the case of many commercial banks in LDC's that do not find it profitable to invest resources in rural areas, because the expected profitability, given the high level of risk, is too low.

Lowering the credit risk threshold (#2) is a subjective decision that a lender can take for several reasons. He can decide to follow an aggressive marketing strategy in order to promote his activity and, thus, accept to bear a higher risk with the aim of expanding his market share.

The lender may also be driven to accept higher risks because among his institutional objectives there is the promotion of economic growth in special sectors of the economy, like the rural sector. Development banks may be classified into this group, since they should promote access to credit by potential customers neglected by other financial intermediaries because of their higher risk and lower profitability.

Following a strategy like this, however, does not mean that the lender should accept any credit risk for the sake of its development objectives, withouth any respect of economic and financial equilibria. The threshold can be lowered but the lender should always be in a position to preserve its present and future viability. Unfortunately, many development banks do not (or did not in the past) consider the negative effects of too high credit risks on their possibility to survive in the long run.

The third behavioural hypothesis, typical of informal lenders, is probably the wiser. A lender should always try to reduce the credit risk as much as possible, before taking any decision on acceptance or refusal.

Effective tools in this respect may be:

-ad hoc credit evaluation techniques that take into consideration the difficulties in gathering information on rural customers

-application of the most suitable conditions on loans (amount, maturity, interest rates, collateral), favouring a regular repayment.

As concerns the lack of information, looking at creditworthiness evaluation procedures in informal markets, we realize that in this context the absence of information commonly used in financial analysis -complex revenue measures, liquidity ratios, stock turnover- is not considered a relevant factor preventing the realization of financial transactions. There should be, then, an alternative way to measure customers ability to repay which is proving to be effective in these markets. Presumably informal lenders base their evaluation on what we may call "symptomatic information", i.e. on information that can very well be interpreted as symptoms of customers' economic and financial conditions and of their ability to repay, with a reasonably low error margin.

If lenders could single out which symptoms -say:diversification of the customer's business, his/her particular behaviours as depositor- are more relevant in determining creditworthiness in their area of intervention, they can build their own credit evaluation systems based on these findings.

Informal lenders migh have a comparative advantage over banks in the evaluation process because of the closer contact between borrower and lender in informal markets, but similar conditions could be achieved also by banks through a suitable branch network[6].

As regards the second aspect -the control of credit risk- the contemporaneous setting of loan amount, loan price and other clauses such as maturity and collateral required, in accordance to the customers profitability, contribute to determine the individual loan credit risk[7].

Techniques to control credit risk, based on a proper definition of loan conditions imply that, since production and profitability conditions differ substantially among customers[8], a good credit risk control policy should aim at applying different sets of conditions for different customers.

A policy of uniform conditions, like those usually applied by development banks financed through external/public lines of credit[9], acts against risk control strategies.

This third approach aiming at controlling credit risk through a different use of information available and an application of ad hoc conditions on loans can in principle be considered the best but might be not feasable for some intermediaries.

Gathering alternative information on customers, considered as symptoms of their economic and financial performance, as well as having a good personal knowledge of the customers that substitutes for the lack of accounting information, implies heavy additional costs for a bank with a reduced branch network.

Also the application of suitable conditions on loan to rural customers may not be economically convenient for certain kinds of intermediaries. For instance, one

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[6]This aspect will be treated later in this paper.
[7]The important effects on credit risks of the simultaneous setting of interest rate, maturity, loan size are analytically explained in Demattè, Valutazione della capacità di credito.
[8]See Meyer and Alicbusan, Farm-Household Heterogeneity.
[9]See chapter 3.

strategy to control for credit risk might be to limit the amount of the loan granted, in order to match it with the real customer's repayment ability[10]. In some cases, however, banks' operating costs set a lower bound to the amount of loans, under which the operation is not profitable.

In some other cases banks are not allowed to diversify loan conditions, especially when they lend to credit project target groups. We will go back to this issue later in the paper.

One sector of the financial market that better succeeds in adopting effective tools to control for credit risk in rural areas is the informal sector to which we devote the following paragraph.

2 <u>THE HANDLING OF CREDIT RISK BY THE INFORMAL MARKET</u>

2.1 WHO ARE THE INFORMAL INTERMEDIARIES

The informal financial market groups all those intermediaries that are not regulated by the monetary autorities and work with a low degree of formalization of their transactions[11].

The informal financial market is very heterogeneous and gathers intermediaries with different objetives, operating principles and target customers. We can group informal intermediaries in four major categories:

1. Individuals lending for solidarity purposes (relatives, friends, neighbours)

2. Individuals lending/collecting funds as their main or secondary activity (moneylenders, moneykeepers, traders)

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[10]Very often rural customers, when required to express their real credit demand, do not apply for very important amounts of money since they want to receive a sum tailored to their specific investment opportunities and needs. See, for instance, data reported in Cuevas et al., <u>Financial Markets in Rural Zaïre</u>.
[11] This chapter is built upon the Author's personal experiences in African rural areas and on information found in specific publications on the subject. Literature on informal financial markets is very rich. One of the most recent publications is Adams and Fitchett, <u>Informal Finance in Low-Income Countries</u>. A clear classification of informal financial intermediaries is provided in Seibel and Marx, <u>Dual Financial Markets</u>.

3. Groups established for different purposes (i.e. social or professional associations) including a credit component among their various activities

4. Groups established for the exclusive purpose of financial intermediation (ex. credit unions)[12].

It is quite difficult to summarize in few pages the different approach to financial transactions adopted by each intermediary, since contracts and conditions vary considerably among them, depending on their overall purposes, their social base, their historical background.

However, there are some features of their working principles that are common to all of them and that differentiate them from the intermediaries of the formal financial market. The following paragraph focuses on the main characteristics of the four categories mentioned, with the aim of highliting this differentiation.

2.2 WHAT ARE THEIR OPERATING PRINCIPLES

1. Individuals lending for solidarity purposes

Solidarity within specific social groups is a major issue in Africa and pervades the life of rural peasants

Financial transactions originated from solidarity purposes may take very different forms, depending on the contingent needs of the borrower and on the lender's ability to respond to these needs.

The reason for borrowing from relatives and friends is often related to some emergency needs (ceremonies, consumption, damage coverage). As a consequence lenders adapt the lending agreement to the conditions the borrower can offer at that very moment.

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[12]Some of the intermediaries belonging to this fourth group may very well be classified as formal, since they reach a sufficient degree of formalization in management and financial transactions. However, even if sometimes they are under the supervision of a specific Ministrer (i.e. Ministrer of Rural Development) they are seldom regulated by the monetary authorities. For this reason, and considering the fact that they are grass-root organization whose formalization is achieved progressively, we can consider them informal or semi-formal. This view is also expressed in Gardiner and Carvalho, Rural Financial Market Development in Lesotho.

Common characteristics of loans granted in this case are:

-immediate disbursement;
-small amounts (as compared to minimum bank loans);
-flexible maturities;
-loan charges not explicitely applied (in some cases inexistent, in other cases implicitly included in the repayment conditions)
-collateral not necessarily required;
-recovery procedures and recovery penalties not explicitly established; honour as a major stimulus for repayment;
-loan repayment at the borrower's or lender's residence;
-verbal loan agreement;
-credit evaluation and lending decision based mainly on personal knowledge or forced by social pressure.

When analyzing this category of loan agreement, it is quite difficult to judge the economic advantages for the lenders, since social considerations intertwine with economic conditions and render any convenience analysis very difficult to perform.

2. Individuals lending/collecting funds as the main or secondary activity

In rural areas many individuals that benefit from a priviledged social and economic position manage different kinds of financial intermediation per se or linked to other activities, such as the sale of goods.

Moneylenders are usually represented by wealthy people that use their own funds or borrow from other intermediaries (banks) and on-lend the money to beneficiaries otherwise neglected by the formal market because considered non-bankable.

As opposed to case #1, these individuals do financial intermediations for the sake of gain; they might use lending as a promotional tool to expand their sales or supply production inputs to farmers on credit, with the aim of reducing the final cost of the output that they will buy.

Loan agreement usually foresees:

-immediate disbursement;
-small amounts (as compared to minimum bank loans);
-flexible maturities;
-loan charges explicitely applied in the form of very

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high[13] interest rates or implicitly included in the repayment conditions[14];
-collateral often required (ex. pledge of future production);
-repayment procedures and recovery penalties very effective and usually well known by the borrower even if not written; honour and will to be eligible in the future as stimula for repayment;
-loan repayment usually at the borrower's residence
-verbal loan agreement;
-credit evaluation and lending decision based mainly on personal knowledge together with profitability evaluation based on symptomatic information when classical information are not available.

The rationale of these individuals' financial transaction lies clearly in the possibility of making profit out of this activity.

There is a great debate on the question of high implicit or explicit interest rates applied by moneylenders that will be later discussed in this paper. One thing that might be recognized is that they cover a special area of the financial market demand, taking big risks, filling an important gap of the formal intermediation and often creating a sort of link between the informal and official markets.

3. Groups established for different purposes including a credit component among their various activities

Social or professional associations are increasingly expanding in Africa. Their aim is to satisfy specific needs of the members, like trade-union or other categorial interests, women promotion and so on.

Since access to credit is almost always among the unsatisfied needs of rural population, a credit component is sometimes included in the objectives of the group.

Usually the rationale for this intervention is to benefit the group's members, whereas profitability might be a secondary objective. In some cases a loan scheme is foreseen only for emergencies (solidarity

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[13]Moneylenders are commonly considered to apply usury interest rates. On this subject see paragraph 2.3.
[14]The mentioned case of input supply on credit where the repayment is combined with the purchase of the goods produced at a price fixed by the moneylender is an example of implicit cost of borrowing.

loans), in other cases it is a more continuous activity of the group which may also borrow from a bank and on-lend to members.

Usual characteristics of loans are[15]:

-disbursement: it may be immediate or follow some specific decisional processes that take a certain time (usually lower than in banks);
-small amounts (as compared to minimum bank loans);
-maturities: they depend on the group working principles and may or may not be established initially;
-loan charges may be applied or not;
-collateral not always required;
-repayment procedures and recovery penalties may be established; honour as stimulus for repayment;
-loan repayment at the group headquarters;
-verbal or written loan agreement;
-credit evaluation and lending decision based mainly on personal knowledge.

4. Groups created for the exclusive purpose of financial intermediation.

In this categories we can include those associations whose aim is to favor access to savings or credit services by their members.

One of the simplest form is the savings and credit association -SCA[16]- where members contribute periodically to a common central fund that is then lent out to members according to certain priority rules.

The idea behind the SCA is twofold:
1. educate members to savings;
2. allow members to have access to credit in bigger amounts than their personal savings could allow at a certain time.

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[15]All the conditions on loans described here are somehow approximate because they vary a lot among different groups. In some instances they are more similar to loan conditions applied by individuals in category #1 (solidarity loans); in other instances conditions are comparable to those applied by credit unions (see #4)

[16]Savings and credit associations may be rotating ROSCAs or non-rotating NROSCAs. They take different names in various African countries: tontines in all West Africa, djanggi in Cameroon (Bouman, Indigenous Savings and Credit Societies) stokofele in Lesotho (Gardiner and Carvalho, Rural Financial Market Development in Lesotho), likilemba and musiki, in Zaïre.

SCAs may evolve and extend their initial objective to other fields but the main purpose remains financial intermediation.

The ideas behind more sophisticated forms of financial intermediation groups are very similar to those of SCAs except that, in the case of credit unions or similar groups, they are more formalized and regulated. They tend to approach their working principles to those of the formal sectors but they preserve some peculiar conditions that render them more successful than the formal sector in effectively offering credit to rural customers.

If we consider the credit union type of intermediary[17] we can summarize loan agreements as follows:

-disbursement: it follows some specific decisional processes that take a certain time (usually lower than in banks)
-small amounts (as compared to minimum bank loans);
-maturities: established in the group managing principles and applied to each contract. They are usually more adapted to the customers' needs than development banks loan maturities;
-loan charges are usually applied in the form of interest rate (often higher than concessionary interest rates of development banks but lower than moneylenders interest rates) and other fees;
-collateral required depending on the kind of loan;
-repayment procedures and recovery penalties esplicitely established; honour and possibility to be eligible again in the future as stimula for repayment;
-loan repayment at the group's headquarters;
-written loan agreement;
-credit evaluation and lending decision based mainly on personal knowledge, some profitability indicators established in the union managing principles, and on depository past performance of borrowers.

Credit unions' main purpose is to benefit their members, offering them financial services at accessible conditions in term of costs, amount deposited and borrowed, proximity, and so on.

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[17]Roscas operate in a more "informal" way than credit unions, which means, for instance, verbal agreements and often implicit interest rates. In our list we focus the attention on credit unions, the most formalized, being aware that many other agreements may take place, half way between the totally informal agreements and credit unions principles.

Many of them, however, especially in recent years, consider profitability an important objective to be preserved, not per se but in order to survive and continue offering their services to an increasing number of members.

2.3 THE SUCCESS OF THE INFORMAL MARKET IN SERVICING ITS CUSTOMERS

If the number of people reached by a financial intermediary is a criteria to judge its performance, it appears that the informal financial intermediaries mentioned above are quite successful. In almost all African countries it is easy to verify that financial intermediaries belonging to these categories cover the major part of rural financial markets demand[18].

A better qualification of the performance of a financial intermediary requires that one looks not only at the number of customers but also at the ways these customers are serviced, i.e. the quality of services offered, the quality of their loans and the viability of the institution.

From this point of view, a first remark is immediate observing that these intermediaries are always contacted voluntarily by the potential customer. The continuity of their activity is then a sign of their effectiveness in offering services to customers that, in turn, continue requiring their intervention.

The quality of their loans (i.e. repayment rates) is almost always satisfactory for moneylenders who otherwise would give up lending activity. It is hard to say whether repayment rates are good in the other lending groups, since they vary a lot among groups. It is more likely that repayment rates are better when lending policies established by the lending group (i.e. credit unions) are seriously observed[19].

Good repayment rates are not only a sign of good performances of lenders but also a sign of effectiveness in servicing customers. If the loan is

[18]See, for instance, the studies on Zaïre (Cuevas et al., Financial Markets in Rural Zaïre), Sénégal (C.I.L.S.S., Différentes formes de crédit et d'épargne), Lesotho (Gardiner and Carvalho, Rural Fiancial Market Development in Lesotho).
[19]Loan quality of credit unions vary a lot among them. They are usually better than repayment rates of development banks. See, for instance, Viganò, Intensificazione dei processi finanziari.

tailored on customers investment needs and actual ability to repay, it is more likely that he/she repays on time and without difficulties.

As concerns profitability performance, moneylenders are generally considered the category of lenders that benefit the most from this activity, given the high interest rates they charge on their loans. Interest rates applied by moneylenders are often considered usurious and deriving from the monopolistic position of the lender[20].

This is often true; however, some Authors[21] state that interest rates as high as moneylenders' are often justifiable if one considers:

-the high degree of risk involved in the transaction
-the flexibility of conditions on loans (ex.maturity)
-the costs of administering these loans
-the collateral services offered by the moneylenders (ex. marketing of production).

To support this position, we might observe that, being rural customers rational[22], their choice to accept moneylenders conditions on loans demonstrates that they implicitely recognize a certain fairness of borrowing charges[23].

The same consideration applies when evaluating the fairness of interest rates in credit unions, often higher than formal market interest rates. Credit unions usually explain this fact with the need to remain viable in the long-run which implies having revenues from lending high enough to cover interests on deposits, operating expenses, and to reinvest in the union.

Members usually accept these conditions since they are aware of the importance of the union survival, besides the fact that if the union is pofitable they will get back a dividend that partially compensates for the cost of the loan.

Furthermore, it is important to stress that the benchmark cost of credit is usually represented by loans from development banks.

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[20]Bottomley, Interest Rate Determination.
[21]See, for example, Wilmington, Aspects of Moneylending and the exposition of Von Pischke, Finance at the Frontier.
[22]Adams, Arguments for Cheap Credit.
[23]Of course, we assume that the borrower is not under the pressure of some emergency.

These banks often apply much lower nominal interest rates on loans. However, their location, often farther than informal lenders location, their waiting times for disbursement, and their heavily bureaucratic procedures represent an implicit increase in the total borrowing costs that outweight the potential benefits of the lower interest rates[24].

A last observation on the interest rates question. If we do not consider loans for solidarity purposes, we can see that, generally speaking, interest rates are lower when the other conditions on loans are less flexible.

In fact, development banks apply the lowest interest rates and offer standard contracts uniformly applicable to all customers of a certain category, credit unions apply higher interest rates and moneylenders -whose condition are the most flexible- apply the highest interest rates.

This direct relationship between interest rates and flexibility of conditions (repayment schedule, waiting time for disbursement, repayment place) suggests that a higher interest rates compensates for the higher quality (better tailored to the customer's need) of services offered.

If we adopt the definition that an Author[25] gave of the way financial markets offer their services, we can say that the informal market takes a "demand-following" approach since it adapts to customers' needs. This attitude is always opposed to the "supply-leading" approach of the formal market, especially development banks[26].

3 THE HANDLING OF CREDIT RISK BY CREDIT PROJECTS

3.1 HISTORICAL BACKGROUND OF CREDIT PROJECTS

The story that many African financial systems went through in the last decades taught that the contribution of foreign financing to financial and

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[24]These additional costs are defined as transaction costs. See, among others, Von Pischke, Finance at the Frontier.
[25]Patrick, Financial Development and Economic Growth.
[26]On this problem see chapter 3.

economic development can be both very beneficial or disruptive, depending on the way it is integrated in local economies.

Referring to the presence of foreign capital in African banks, and in particular in those development banks where it represents the bulk of liabilities, foreign financing was justified by the idea that an injection of money through these banks into the economy -especially the weakest sectors (i.e. agriculture)- was necessary in order to promote take-off.

For this purpose, money was offered to development banks at low cost in order to allow these banks to on-lend the money received to rural people at concessionary interest rates.

The history shows that, contrary to expectations, foreign financing failed to reach the stated objectives and has been in many instances partially responsible for the serious problems that development banks have to face, reflected in the quality of their loan portfolios.

The reason for this conviction does not lie in an ideological adversion for foreign capital but in a disagreement upon the conditions on which these amounts of money are offered to banks. The main observation in this respect concerns the high level of interference of foreign financiers in banks' credit policy[27].

The financial doctrine defines financial intermediaries - and in particular banks - as the economic units that operate a series of transformations on financial instruments characteristics -maturity, risk, price, location, amount- so that both surplus and deficit units are satisfied with financial transactions. The bank's success in these transformations strongly depends on its ability to match borrowers and lenders requirements with its internal operating conditions and its economic and financial equilibria.

In a bank operating according to this standard, depositors influence the bank's decisions because the latter has to adjust its management, lending strategies and contracts to the conditions at which depositors are able and available to buy a deposit. Depositors, hovewer, cannot and do not want to intervene in the establishment of lending policies and

[27]See Masini, Preface and Von Pischke, Finance at the Frontier, Chapter V, pp. 93-115.

conditions, once they trust the bank and are satisfied with the remuneration and other contract terms on their deposits.

Foreign financing, on the contrary, was (and in many cases is) offered to the banks with the esplicit or implicit assumption that the financing agency can and must control the use of funds made available. This is against the common view previously stated that sees the bank's management as the only entity entitled and effective in making any decisions about the use of internal and external resources.

Also many African governments made available resources to banks following the same 'control approach'. As we shall see very soon, any observation about the effects of funding on bank management is more related to the way and conditions on which funds are offered, rather than on the identity of the financier.

For this reason we can consider both foreign resources and public funds involving strict external control as captive sources of funds[28] and we examine their common effect on the bank and on the effectiveness of credit schemes promoted through them.

3.2 THE TYPICAL CREDIT SCHEME AND ITS SHORTCOMINGS

A typical captive financing is an agreement where the lending unit makes available to the bank a line of credit whose use is bound by specific directions on the type of beneficiary and on lending prices and conditions.

For instance, a development bank may receive a line of credit with the purpose to promote mechanization of farmers in a certain area of the Country. Usually the donor promoting the initiative makes funds available under the implicit or explicit assumption that the bank will follow lending criteria agreed upon with the donor; conditions established will apply on all the target group beneficiaries.

A first shortcoming of this approach is the lack of bank's authonomy in the decision making process. It is important to notice that, while the external intervention is usually very strong in the disbursing phase of lending, repayment performance is not usually subject to much attention.

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[28]See Masini, Development Choices, pp. 220-237.

More generally, 'captive' financiers exercise their control on partial aspects of bank management instead of focussing on the overall bank performance, which should represent the most useful criteria in their evaluation[29].

Secondly, and as a consequence of what just stated, in the majority of cases the imposed lending policy is in serious contrast with the bank's economic and financial equilibrium and with the intended beneficiaries' preferences. This results in very poor lending performance and returns, whose effects on overall bank profitability are often ruinous.

Low returns on lending find an apparent justification in the low contractual cost -in terms of interest rate- of captive resources. Hidden costs of these sources of financing -i.e. the effects on bank portfolio quality[30]- increase the actual borrowing expense. Nominal low cost of these resources, in turn, has strong crowding out effects with respect to market sources[31].

3.3 HOW THE CREDIT SCHEME AFFECTS CREDIT RISK

The negative effects of distorted captive financing reflects principally in the high level of insolvency characterizing the banks involved. As already stated, low repayment rates are evident signs that the lending process is not well conceived and that the loan agreement contains some elements that do not fit to the customer.

The major cause of insolvencies, in this respect, is the lack of correspondence between customers' financial preferences and imposed banks' products.

There is a blooming literature related to people financial behaviour in African countries[32]. We can

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[29]Masini, Preface.
[30]Another element of cost of foreign resources is the effect of exchange rates that may modify the advantage of low nominal interest rates. Masini, Preface.
[31]Masini, Preface. On the importance of savings mobilization see paragraph 4.1.
[32]See, among others: Adams, Graham and Von Pischke, Undermining Rural Development; Masini, Rural Finance Profiles; Mauri, problematiche finanziarie; Von Pischke, Adams and Donald, Rural Financial Markets.

learn from it that an important percentage of urban and rüral population, small entrepreneurs or common workers, show a definite preference for transactions in the informal market.

As we stated earlier, prices and conditions prevailing in this market better satisfy these customers. A bank that wants to be customer-oriented has to pay attention to customers' preferences and try to adjust to them consistently with the conditions imposed by its internal equilibria.

Even if a total transposition of informal contracts in the bank universe might be difficult to achieve, because of different operating conditions and structures in the two markets, a certain adaptation and flexibility of formal contracts seems to be the only way to efficiently reach potential customers.

Lending policies imposed by 'captive' financiers are usually very far from this approach and tend to foresee uniform and inflexible contracts to be applied to the entirety of targeted customers[33].

This is also in clear contrast with any proper credit evaluation theory and credit risk control approach that, as we saw before, relies on the possibility of setting specific conditions on loans for each customer.

From this point of view, uniform application of loan conditions affects credit risk also through its effects on the customer's perception of the loan contract.

A customer's creditworthiness could be seriously compromised by a mismatching between loan conditions offered by banks and the conditions he/she estimates is really able to face. Given the customer rational behavior -which has been proved by many studies, also for very small and subsidence economic units[34]- customers' preference for informal markets reflects their rational feeling that informal contracts are more suitable to their operating and economic conditions and, then, that they will be able to honour informal obligations.

At this point an apparent contrast arises between the rationality of farmers and their diffused acceptance of standard banks' loans. Two alternative explications are

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[33]Offering standard contracts without considering customers preferences is typical of the "Supply-leading Finance"; Patrick, Financial Development and Economic Growth.
[34]Adams, Arguments for Cheap Credit.

possible; one is that loan conditions are actually tailored upon customers ability to pay and the second possibility is that some other rational reasoning prevails in customers' minds.

While the first option is strongly contradicted by the high level of insolvencies in case of standard contracts, it is interesting to investigate the second option. What rational choice could lead a farmer to accept a loan from a rural development bank, even if he/she realizes that loan conditions would not allow him to pay back the loan? The only possible rational motivation is that his intention is not to pay back the loan (this attitude can be interpreted as a result of an "adverse selection" process[35]). This conclusion appears somehow trivial but hides some important consequences for banks future lending policies.

In such a situation the farmer acts as if he received a grant which does not require any calculation of ability to repay. The only comparison he needs to make is between the utility of the subvention, the cost to obtain it and the cost implied by his default. The latter usually involves the loss of opportunity to get another loan (subvention) and the social cost in case his default is known by people in his community. This social cost is much greater if the lender is esteemed and respected by the borrower's community, while can become insignificant in the opposite case.

The image that banks, especially public development banks, projected on their target markets was (is) very different from what a proper financial intermediary should appear. The bureaucratic approach implied by public or foreign financed lending projects contributed to instill false ideas of the proper role of banks, often perceived as entities merely concerned with the distribution of public or foreign funds within the framework of development promotion through fiscal policy.

Very soft recovery procedures in case of default contributed to foster this idea[36]. This false image led potential customers to estimate very low costs of default, as defined above. The borrower's behaviour, then, should not be viewed as totally dishonest but at least partially induced by a distorted relationship with the bank.

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[35]For a description of the adverse selection process see Stiglitz and Weiss, Credit Rationing.
[36]Masini, Preface; Mauri, Il contributo dell'innovazione finanziaria; Sanderatne, An Analytical Approach.

This element of credit risk often contributes very heavily to increase total individual lending risk. The results of a research I have just terminated on a West African agricultural development bank show that customers attitude is one of the major determinants of repayment uncertainty.

Removing the distorsion in the bank's image caused by the bureaucratic approach of public or foreign financed projects, does not necessarily imply the elimination of its effects. The heavy heritage in terms of false image is one of the major problems that banks have to deal with now.

Changing the people's attitude towards banks requires quite a lot of time and can only be achieved through strict adoption of new lending policies and marketing strategies. Lending obligations and recovery procedures should be clear and effective so that no misunderstanding can happen any longer. Incentives for those customers who demonstrate uprightness and precision in fulfilling the contract might be a very useful promotional tool.

4 HOW TO SOLVE THE PROBLEM

4.1 THROUGH DEVELOPMENT OR COMMERCIAL BANKS

The preceding observation highlighted that past conception of credit projects contained many weak points that should be avoided if these projects want to effectively contribute to financial development.

Lines of credit on-lent to project beneficiaries following bureaucratic schemes should be abandoned. Instead funds should be made available to banks at adequate conditions and banks should lend them according to correct banking principles.

In order to be successful banks must adapt these banking principles to customers' preferences and characteristics. This means finding new savings and lending contractual schemes more suitable for the target customers and, in the meanwhile, allow the bank to preserve economic and financial equilibria. The long-run survival of financial intermediaries is in fact a condition sine qua non for stable financial development.

Given the recognized success and ability of informal market agreements to satisfy customers , new savings and lending policies adopted by banks, should, when possible, try to duplicate these conditions -the mentioned "demand-following approach"-.

According to this view, the analytical framework proposed in the preceding pages suggests some important directions to follow in order to implement an effective lending policy, that we may summarize as follows:

-Establishment of an acceptable level of credit risk, in accordance with bank's overall development policies and profitability.

-Establishment of ad hoc credit evaluation criteria which enable the bank to obtain reasonable estimates of credit risk. This step implies the adoption of two kinds of "symptomatic information". The banks should look not only for "symptoms of the customer's ability to repay" but also, and even at an earlier stage, for "simptoms of the customer's willingness to repay" which is related to the quality of the bank-customer relationship, as previously explained.

-Flexible use of contract terms and conditions to adjust to customer's preferences and to allow for credit risk control -i.e. interest rate, maturity, collateral requirements-.

-Establishment of strict recovering procedures for normal repayments and in case of default, to be known by the customer at the time of loan agreement[37].

-Establishment of standard loan analysis procedures to be uniformly implemented at different levels and in different branches of the bank's network.

The last step is crucial and is the key element for all the other steps to be effective. A uniform decision making system that coordinates the acceptable credit risk level with the criteria to evaluate it and the techniques to control it, made available to the banks personnel at all levels according to the different roles in the lending process, has two main advantages. First, it assures a homogeneous lending behaviour among bank officers, according to general guidelines previously stated at central level; second, it allows the implementation of an effective lending control system in which any shifting of bank officers from the established criteria must be duly justified.

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[37]Masini, Preface.

The ėstablishment of general guidelines becomes strictly necessary if the bank wants to start a territorial coverage policy which implies - the allocation of banks agents or the creation of new branches. Every branch loan officer should be given a certain flexibility to modify loan evaluation or lending terms and conditions -to adapt them to local situations- but the common framework should act as a landmark in the whole process.

Decentralization favours a better knowledge of customers, which is one of the strongest points of the informal markets. A more complete knowledge of customers behaviour can be reached if the relationship with the customers becomes two-sided[38], i.e. when the customer is at times depositor and lender with the same bank, in accordance with his/her seasonal financial flows.

The strict link between customer's savings and their eligibility as borrowers is typical of credit unions and determined their relative success. Transposing similar principles to banks could be beneficial for credit risk control strategies.

Furthermore an active savings mobilization policy, affects positively the overall quality of lending portfolio[39] for another important reason.

The use of market resources, instead of captive sources of funds, implies a direct market control on the bank. Depositors are attracted towards a bank by its seriousness, stability, efficiency and ability to satisfy their needs, in terms of price and services offered. Lending policies are an important element influencing depositors' decisions as they strongly affect banks' overall performance and image. The presence of market funds, then, stimulate a more efficient use of resources collected.

The effects of this restructuring of banks involved in credit projects result in similar structures of assets and liabilities of development and commercial banks: savings mobilization as an important source of funding and lending based on selective criteria, though adapted to the typical rural customers.

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[38]Von Pischke, Finance at the Frontier, p.310.
[39]Masini, Preface.

The rationale for this approach is that financial development can only be achieved if financial intermediaries work efficiently and continuously in the area of intervention. Efficiency and effectiveness can be better achieved in banks that operate on the two sides of the market (savings mobilization and lending) and that implement correct credit selection and follow-up policies; this is true for both commercial and development banks.

What makes a difference between commercial and development banks is the level of risk they want to bear. A bank with institutional development objecties may be able to accept a higher level of credit risk in order to give access to financial services to those customers whose creditworthiness is more difficult to evaluate than for usual bank customers.

This does not mean that development banks should lend without any credit risk concern, but that they can favour those customers who are creditworthy but that cannot demonstrate their creditworthiness according to standard credit evaluation principles adopted by commercial banks. This kind of credit risk, more related to the quality of information available, cannot however exceed a reasonable threshold, in order to allow the bank to keep its viability.

The suggested new development strategy implies that banks have an adequate structure of branches, allowing them to be in strict contact with their customers. Extending branch networks, however, implies important investments of money that should be recovered through the profitability of new operations.

Given the small size of rural customers activities and, as a consequence, the small size of their financial transactions, the cost implied by opening new branches for them and managing their transactions may not be economically worthwhile.

Besides possible interventions of foreign financing to support costs of opening new branches (see chapter 5) another strategy to reach rural customers could be a structure of two-stage intermediation where the bank interacts with some local financial intermediaries -formal or informal- of smaller size.

4.2 LINKING FORMAL AND INFORMAL MARKETS

The possibility to establish permanent relationships between a formal financial institution of big size, like development banks, and some smaller intermediaries operating in a target area has been exploited in several countries, especially recently[40].

Given the effectiveness of local structures (like credit unions) in servicing their customers, a bank willing to develop its activity in rural areas may find it more convenient to use these structures instead of expanding its own branch network.

This has some major advantages:

-the local structure already has strong links with the territory and is inserted in the social life of the community, which means that it has a sufficient customers personal knowledge and benefits from customers trust;

-the local structure operates on a small scale that a bank could not afford, given its operating costs;

-making funds available in bulk to the local structure which in turn lends to its customers allows both the bank and the local structure to expand their activity and makes available more funds to rural customers.

This approach, hovewer, hides possible dangers, depending on the way it is implemented, especially as far as the choice of the local intermediary and the agreement to be established are concerned.

The choice of the local intermediary should be very careful. Much concern should be devoted to the evalaution of its performance and ability to effectively satisfy customers. Its viability is important; the local structure must demostrate to be creditworthy from the bank point of view, since it will become a preferred counterparty.

In some instances, especially in the past, development banks used administrative structure agencies (i.e. extension services) as channels to reach target beneficiaries. This choice often resulted in failures for several reasons that will be explained in a following paragraph (see chapter 5).

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[40]Many experiences were presented at a seminar held in Abidjan in 1989. Cfr. AFRACA, <u>The role of informal institutions</u>.

The co-operation agreement between the bank and the local structure is also a crucial point. Two major solutions are possible:

-the bank agrees with the local structure that the latter will act on behalf of the bank, being a representative of the bank in the area of intervention. It collects money for the bank, can perform credit analysis and take lending decisions on behalf of the bank of trasmits credit applications to the bank for approval. It takes care of recovering procedures for the bank.

-the bank considers the local structure as a pure borrower. In this case the local intermediary rèceives the money from the bank in the form of a loan that will be on-lent to the structure's customers according to its working principles and operating conditions. The only engagement that the structure has towards the bank concern the timely repayment of the loan received.

While the second solution implies limited risks for the bank, once it has evaluated the structure's creditworthiness, the first solution deserves more attention.

Authorizing the structure to act on behalf of the bank means including it in the bank organizational chart. In this case, it is crucial to verify that the local structure is provided with trained personnel that work according to banking principles.

Furthermore, duties and responsibilities should be well defined at each level of the decision making process, as well as actions to be undertaken in case agreements are not respected should be effective. This is particularly important as concerns loan defaults. The bank and the local structure must define common evaluation criterias and establish who will be responsible for arrears.

The danger of this setting lies in the possibility that a certain dependence relationship and an overcontrol on the part of the bank will occurr.

From the local structure point of view, the danger of strarting a cooperation agreement with a bank may also be represented by its dimensional equilibrium. Many informal or semi-formal financial intermediaries proved to be effective in managing their small-size business. A sudden extension of their scale of operation might go beyond their managing ability, compromising their viability. This fact, of course, reflects back to the bank viability.

5 HOW TO IMPLEMENT A CREDIT PROJECT

5.1 THE LESSON FROM THE MISTAKES OF THE PAST

Credit projects are experienced in many developing countries and demostrated various degrees of effectiveness in achieving their objectives. The purpose of this paragraph is to go through crucial points of their formulation and implementation, expressing proposals to redress them, when necessary, in accordance with the theoretical framework previously presented in the paper.

Credit projects implemented in African countries may be classified according to their declared objectives and particular formulation. Some projects are designed and executed with the unique purpose of promoting the development of financial intermediation; some other projects include a credit component among wider objectives (i.e. mechanization, infrastructures).

Historically, even credit projects initially designed in the same way and with the same purposes followed different ways of implementation because of particular circumstances that occurred.

These circumstances could be classified into two categories: external events and internal circumstances.

External events group every fact that could have influenced the development of the project without being under the project's control: local government decisions, weather conditions affecting production, certain aptitudes of pesants deriving from their culture are examples of these circumstances.

Internal circumstances, on the contrary, are under the project's control as they depend on the choices and policies adopted by project's formulators and executors.

External events are usually difficult to foresee and could be considered as an implicit risk of the project; it is however possible to take some measures to face particular kinds of them (an example is represented by provisions to be made in order to face weather problems; this subject will be tackled later).

Internal circumstances determine the actual feature that the project takes during implementation. It is very likely that these circumstances are responsbile for most of the effectiveness of credit intervention and if some credit projects failed, the reason for failure should be looked for among internal circumstances.

According to the approach proposed by credit project analysts[41], the crucial phases that need to be correctly designed and implemented are the following:

a.definition of the role of the credit component in the general objectives of the project;
b.specialized human resources in project formulation and implementation
c.methods of making funds available
d.criteria for determining the size of the credit component
e.institutional arrangements
f.lending policies
g.linkages with marketing and input supply
h.the problem of weather conditions

a. Role of the credit component in the general objectives of the project

In many unsuccessful credit projects a clear definition of the objectives to be achieved through the introduction of a credit component is absent causing a lack of benchmarks for those in charge of the implementation of the project who cannot compare their performance with expected results.

When the general objective is expressed, however, a lot of attention should be paid in order not to attribute misleading roles to the credit component which may results in even worse results than when the objective is not declared.

As an example, a project's objective to "supply a target group with production inputs on credit" differs substantially from an objective of "promotion of a permanent financial intermediation infrastructure for a target group". While the latter objective is without any doubt a credit project purpose, the former may transform in an objective of "distribution of funds to the target group" far from a real credit scheme.

The issue here is to distinguish true credit projects from social assistance projects. The danger of a possible confusion is clearer if one refers back to the observations of chapter 3, where we highlighted the effects of certain credit scheme on beneficiaries attitude towards financial transactions. The conclusive paragraph clearly explains the Author's position on this subject.

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[41]Focal points to be critically reviewed have been suggested to the Author by FAO officers, on the occasion of a credit projects evaluation assignment the Author performed on behalf of FAO.

b. Specialized human resources in project formulation and implementation

Many projects involving a credit component lack of specialized personnel: credit consultants and experts, trained personnel for the implementation phase.

This choice is debatable. Sometimes credit is considered of less importance than other components of the project; alternatively the credit component is perhaps considered easier to manage than other components. This depends on the view formulators have about what is credit.

As already mentioned, favoring immediate access of peasants to funds from the project or from a bank who has received money from the project often becomes the main objective of what is erroneously called credit component. This task is not so difficult to perform and for that reason the credit consultant is not necessary. But it is easily understandable that this approach has nothing to do with a financial system development that should be the aim of a credit project.

If the project target is to allow farmers to have permanent access to financial institutions (savings and credit) and if the latter are supposed to perform efficiently their intermediation in order to be able to survive in the long run without the project's support, the degree of difficulty in achieving it for people not expert in this field is evident.

It is then advisable to involve a credit expert -who knows very well the area of intervention- at least in project formulation and in crucial phases of implementation; when projects are important it is necessary to have a credit consultant permanently monitoring the credit component performance.

The intial cost of the consultant can be easily recovered through the permanent positive effects his/her intervention should have an the project achievements.

c. Methods of making funds available

Three usual ways of making funds available are the establishment of revolving funds, counterpart funds, guarantee funds.

Revolving funds are amounts of money made available by a project in order to start a lending activity in the project's area. Funds are managed by a local financial istitution when possible, after having signed a letter of agreement with the donor. They can be set up in cash (project money contribution) or through the sales of inputs and other goods made available by the project. In the latter case the revolving fund is called counterpart fund.

The case of counterpart funds is somehow dangerous[42]. Through this scheme farmers pay inputs received from the project by means of loans received from a bank compelled by the project to grant them; funds obtained are then used to establish the revolving fund.

Given the preceding observation about how risk of default is affected in these credit schemes, the bank is bearing most of the uncertainties of the operation. This distorted involvement of local financial institutions in credit disbursement is not in line with an institution building approach as it threathens the viability of the intermediary pushing it to engage in a financial operation that it cannot control.

The guarantee fund is the solution that engages the most local financial institutions' resources. It acts as a guarantee against possible losses arising from lending to target groups (funds loaned amount to some multiple of the guarantee fund). The money used for lending belongs to the intermediary and does not come from the project.

It has been objected that this fund may not be large enough to cover all the possible losses of lending; however, a complete coverage is not advisable since the bank must perform a credit analysis and control the risks of this activity through a free choice of beneficiaries and conditions on loans, according to its managing principles. The guarantee fund is only a device to lower the losses from defaults.

[42]On counterpart funds see FAO, Guidelines for Project Counterpart Funds.

d.Critéria for determining the size of the credit component

In many instances the settlement of the size of the credit component is neglected as it appears that funds are allotted to the credit component without taking into proper consideration the peasants' and the bank's absorption capacity.

This has often resulted in:

-an inability of the receiving bank to manage the excessive amounts of money the project offers;

-a false peasants' appreciation of the utility of funds received as they are not able to invest them profitably (they might accept them and use them not economically, with an increase in default risk). The lack of correspondence between the loan size and the farmers' needs is even greater when loans are granted in kind through pre-defined packages of inputs to be accepted in bulk[43].

e. Institutional arrangements

The choice of the counterparty institution is crucial. In many projects it happens that there is no possibility to choose as only one istitution is present in the target region, or even none.

In the case of only one institution present in the area it is necessary to be very careful in choosing it. Before doing such a choice, it is better to verify how this institution works, if it is viabile and efficient.

If the intermediary is not economically and fianancially healthy it would be better to give up this choice and try to find some other solutions; it is in fact very dangerous to let funds in the hands of an institution not able to efficiently manage them.

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[43]A study performed in the Ivory Coast found better repayment rates for loans in cash than for loans with specific destinations. See Yabile, <u>Default in Agricultural Credit Programs</u>.

In this case, as well as when no financial institutions are present in the region, an effort could be made to develop local resources in order to promote small financial intermediaries dealing with project's funds.

This task is sometimes helped by the presence of already working informal intermediaries and financial associations that could be utilized by the project; in other cases substantial training is necessary.

A micro-approach like this requires a lot of work from educators and trainers in order to be sure that financial principles are assimilated by people charged of the micro-institutions management; this approach requires a lot of time to be implemented if no initiatives of the same kind are already working in the project's area. But the effort is more worthwile than an easier approach with an unhealthy financial institution bound to fail.

A similar kind of problem arises when the project uses a financial institution that is not provided with branches in the area of intervention. In this case it is very common that other extension services and state agencies, that have institutional objectives other than financial intermediation, undertake the tasks of loan disbursement and collection on behalf of the bank[44].

This implies that these agencies get decisional power in loan granting without being involved in risk bearing, as it is always the bank that support the portfolio risk. The agency feels very weakly involved in loan repayment collection as, even if sometimes it is stated that it is jointly responsible with farmers for repayments, it knows that it will bear very few consequences for defaults.

The result is that money is easily disbursed to farmers withouth any creditworthiness analysis (it is also very doubtful that extension workers are able to engage in this analysis, as they have not any banking background).

Following an approach of this kind could fit to an objective to channel funds towards farmors (a "money-tap objective") but not to the target of creating a healthy financial market.

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[44]This happened in Niger. See Masini, La Cassa Nazionale di Credito Agrario del Niger.

Once the choice of the financial institution has been correclty done, it is very important to establish certain conditions that, together with the peasants' access to financial institutions, favour the preservation of the economic and financial viability of the bank involved.

In this view, the question of interest rate on loans is generally a matter of discussion. The argument in favour to low interest rates is that the latter render credit more attractive to farmers.

This in principle is true as the law of demand says that buyers buy more willingly if prices are lower; it is hovewer necessary to consider several aspects that contribute to weaken the low interest rate approach.

The first consideration concerns the economic viability of the institution. A bank has to collect resources to be lent from the capital market, paying an interest rate high enough to make the offer interesting for depositors. Assuming that interests on loans represent the bulk bank revenues, if these interest rates are kept equal or even only slightly higher than interests on liabilities, the resulting spread does not allow the bank to cover its operating expenses and to make a profit. The lack of these conditions implies that the future life of the bank is threathened.

The most common objection to this argument is that the project offers its resources to the bank free of charge or at low costs, in order to allow it to preserve the necessary spread; however this is only true in the short run as, when the project withdraws, the banks remains without this precious source of money[45], which acts against the common objective of these projects to let the areas of intervention continue their self-development after the project's end.

The other common objection already mentioned is that farmers cannot accept high interest rates; as already stated, however, empirical researches found that in most LDC's informal markets, where interest rates are higher than those sufficient to a bank to preserve its spread, are well developed and healthy. Of course, farmers do not like to pay too much to obtain money, but it is demonstrated that, when they willingly accept

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[45]We have earlied pointed out that real cost of foreign resources might be much higher than the nomial cost due to hidden costs, such as the "cost of external intervention" and the exchange rate effects.

to do so, they are able to keep their engagement[46].

An appropriate interest rate also favours a policy of savings mobilization, as it allows the bank to offer attractive remunerations to depositors.

f. Lending policies

Following what said in the preceding paragraph, if the bank has to develop its ability to survive after the project's end, and if the choice of a healthy financial institution has been done, the p oject can be confident in the bank's ability to fix its own lending principles and conditions (interest rates, maturities, diversification of beneficiaries in accordance with the targets of the projects).

Projects' staff (credit consultant) can offer its support and its advice, but decisions must remain solely with the bank.

g. Linkages with marketing and input supply

In some projects lending is strictly linked with production marketing or input supply, or both. Linking a loan to a supply of inputs is supposed to favour a correct (productive) use of funds received; this sometimes happens but it must not be taken for granted.

As already stated, the input packages offered by the projects sometimes do not fit to farmers' needs and ability to exploit them, thus resulting in bad performances and disappointing quality and quantity of output.

It is also proved that if farmers want to divert funds from their expected use, they succeed even with input

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[46]As we already saw, a lot of factors contribute to this situation: informal lenders are more flexible than banks in fixing loan conditions and personal knowledge between the two contracting parties fosters the financial obligation.

packages[47].

The best way to have money used productively is to put farmers in a position to appreciate the value of the expected increase in productivity and income; this is not linked to a loan-in-kind approach but depends on farmers' experience and training (and on basic production conditions and infrastructures[48]).

Even if loans in kind sometiems succeded, linking marketing or input supply with lending pushes the bank to engage itself in activities and to bear risks that are not typical of a financial institution.

h. The problem of weather conditions

One of the most frequent reasons alleged for defaults has been the problem of bad weather conditions affecting the level of production and repayment ability.

Even if sometimes peasants unduly justify their inability to repay with bad harvests, a certain concern arise on the way to face this important problem.

The idea of a state owned crop insurance corporation might be considered, as well as the creation of self insurance funds, already existing in some savings and credit associations.

6 CONCLUSIONS

Efficient financial markets and intermediaries foster economic development because they promote the transfer of financial resources to those economic units (deficit units-entrepreneurs) that can make the most profitable use of funds through investment in their business.

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[47]Von Pischke distinguishes between "loan substitution" that occurs "when a loan is obtained to fulfill an objective that would be achieved without the loan" from "loan diversion" occurring "when funds are borrowed for a purpose not undertaken". The Author says that diversion is more serious than substitution. Von Pischke, Finance at the Frontier, p. 155-156.
[48]See the conclusion.

In developing countries this process is often compromised by the presence of weak financial markets that hardly satisfy customers expectations, expecially as concerns the official markets.

This paper focused on some aspects of rural financial markets weaknesses and found that many times the cause of weak performance is to be found in the way financial development strategies and projects have been designed and implemented.

In particular, development banks failed to achieve their objectives to efficiently service their customers because of the "supply-leading" approach they have been compelled to follow in their credit projects, driven by captive sources of funds.

According to these schemes funds were made available to target customers under the assumption that the lack of credit was a major constraint to their economic development, without paying too much attention to customers' creditworthiness. The lack of customers selection created many problems of loan defaults and transformed credit agreements into subvention schemes.

The critical view of the effects of captive (public and foreign) resources on the effectiveness of financial markets may lead to a choice of complete refusal of these sources of funds.

Still the logic behind the structure of funds flows suggests that the use of this source of financing may very well promote sustainable growth. In fact, even if in many countries savings mobilization can cover a great deal of the domestic demand for credit, it is reasonable to think that, if there is enough effective credit demand and internal resources are not sufficient, it would be anti-economic to give up the opportunity to look for alternative sources of funds.

Between two individuals who have financial balances of opposite signs, a surplus and a deficit unit, the financial transaction takes place with the purpose to transfer resources from the less productive unit to the more productive one -through a credit agreement-.

Likewise, a deficit country or institution who has more investment opportunities than internal resources should look for a potential partner in its financial transaction, namely a surplus country or foreign institution.

There is then a strong argument in favour of a complementary use of local and foreign financial resources for bank funding.

A caveat that should be clear, hovewer, is that in order to allow external and public funds to exercise their beneficial action, the dangerous approach described above of strict intervention in bank management must be abolished. External and public funds should be made available upon conditions that equalize them to local funds in banks' funding choices[49]. They must compete with the local market on a fair basis where pricing conditions are clear and rights and obligations are the same, in local and international contracts.

A correct role of external resources, then, should be the following:

-if a project offers funds to a bank, conditions of disbursement and repayment to the project must be correctly established in the letter of agreement, avoiding all those clauses that imply heavy external interference by donors in fixing the internal bank policies (i.e.: pre-dermined credit schemes) and making the bank responsible for loan quality;

-as an alternative, instead of making funds available for the purpose of lending, the project could offer funds to support some special interventions, such as the creation of new branches and training of personnel. These activities influece positively the financial activity of the bank without having the shortcomings exposed before (lack of responsibilization, permanent dependence from external resources).

We are obviously assuming that the banks involved can effectively manage themselves in order to make the most profitable use of resources received both from depositors and external funding. In fact, bank viability and efficiency should be the preliminary condition of every credit project.

Being viable imply that banks should adopt correct savings and lending policies and should manage their loan portfolio with the view of keeping credit risks at an acceptable level.

As we saw, in the case of rural customers, the bank must adopt ad hoc credit evaluation schemes that better fit to the kind of information available. Still once the bank has evaluated a customer's creditworthiness it must limit risk exposure refusing loans to those potential customers not deemed creditworthy.

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[49]Masini, Preface.

This approach may be considered too conservative if compared to previous credit schemes less selective in loan granting. However, given the problematic situations that many banks went through because of defaults, often leading to failure, it is necessary that banks take actions to preserve their viability.

Granting credit to non-creditworthy farmers has the unique effect of transforming the loan in a subvention or a gift. If this is the case, one wanders why should a bank be involved in such a net trasfer of wealth, which goes beyond the bank's institutional objectives.

Instead, fiscal policies to promote development of the "poorer" rural potential customers should be implemented through the provision of the necessary infrastructures, allowing them to become creditworthy in the future.

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SEMINAR ON FINANCIAL MARKETS: CENTRAL BANK OF LESOTHO, MASERU MAY 25-27, 1992

"The Evolution of Regional Financial Systems - Influences and Implications for Southern Africa"

By Laurence C. Clarke, Ph.D.
Deputy Governor,
Bank of Botswana

Mr. Chairman,
Governor Maruping,
Distinguished Ladies and Gentlemen,

I am personally delighted, as is the Bank of Botswana, to be a part of this important seminar on financial markets. As I understand it, the seminar seeks to principally examine Lesotho's emerging financial structure in the context of the well-known dynamics of the Southern Africa region, of which we are all a part. The effort of the Central Bank of Lesotho to organise and realise this forum must be commended. It is my fervent hope that my humble contribution this morning will in some modest measure help to shape whatever positive conclusions finally emerge from our deliberations over the three day seminar period.

I would today like to deal with two broad themes in this paper, primarily from the Botswana perspective, and reflecting, in a way, the two actual areas I was earlier asked by Governor Maruping to address. Regrettably, I may only be able to formally present one of these areas to the conference, but I have nevertheless decided to formalise my thoughts on both scores in this document. I sincerely hope that this effort does not give rise to too many complications to readers of interest.

The paper is divided into three sections. Section I briefly sets out the economic context of Botswana at independence and since; Section II traces Botswana's financial development over the past 25 years and often contrasts the path pursued with that of Lesotho's, reflecting influences of the region and the developed world whenever possible;[a] *The final section,*

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a/ Sections I and II are in several areas close adaptations and modifications of an earlier presentation made by Governor H.C.L. Hermans, of the Bank of Botswana to a recent seminar by the Reserve Bank and the Financial Services Board of South Africa. The paper, which was also issued in a longer technical version, with the assistance of the author of this paper, was entitled "The Emergence of the Financial Sector in Small Developing Economies: Botswana's Experience."

Section III, details a number of issues, lessons and implications that will shape the financial course that emerging nations in the region, such as Botswana and Lesotho, could well pursue in the rest of 1990s and beyond.

I. Botswana's Economic Growth Since Independence

At Independence, twenty-five years ago, Botswana was, like Lesotho, one of the poorest countries in the world, with a per capita income of less than US$60, and with Protectorate status denying it even the modest development which colonies at that time enjoyed. Low-level, drought-prone subsistence agriculture dominated Botswana's economy. Cash needs were met by selling a few cattle to local traders or working in the South African mines. Even the most basic physical infrastructure was lacking. The economy was desperately poor in every respect. Botswana is still the only African country to have achieved independence without a single Government secondary school! Physical infrastructure in both urban and rural areas was grossly rudimentary and very limited.

Not surprisingly, Botswana's financial sector initially mirrored its economic backwardness. When the nation moved its administrative headquarters from Mafikeng to Gaborone in 1964, the financial sector comprised two commercial banks, both branches of South African banks, and a Post Office Savings Bank, which had also been administered from South Africa to facilitate the repatriation of migrant workers' remittances. This did not appear significantly different from Lesotho, except that the latter seems to have been at that time, and still is, somewhat more dependent on migrant labour.

In the late 1960's in Botswana, there were no insurance companies, no pension funds, no merchant banks, no building societies and no stock market. From a monetary perspective, Botswana was, like Lesotho, just another province of the Rand Monetary Area. South African exchange controls governed all foreign transactions in both countries, as is still the case to some limited extent in Lesotho, by virtue of its continued membership in the Rand Monetary Area. Botswana depended on annual grants from Britain to balance its budget until 1972.

The discovery in the late 1960s of copper-nickel deposits near what is now Selebi Phikwe, large coal reserves at Palapye, and kimberlitic diamond pipes out in the Kalahari, together with the renegotiation of the 1910 Customs Union Agreement in 1969, led to the transformation of Botswana's economy. With a population at independence of less than one million people, it did not, admittedly, take much investment to generate high rates of economic growth. Nevertheless, Botswana's development since then has been spectacular, even by global standards. Real growth during the first twenty years of independence averaged 13% per annum. The increase in real per capita income from 1975 to 1988 was second only to Singapore's. Botswana has become the second largest diamond producer, by value of production, in the world.

With GNP now exceeding P7 billion (or almost R10 billion), Botswana continues to demonstrate one of the strongest economic performances currently witnessed in both developing and developed countries. What is more remarkable is the fact that, despite one of the highest rates of population growth in the world since independence, per capita income has risen progressively to more than US$3,000. Prudent economic and fiscal management, a stable democratic political environment and an increasingly liberal exchange control regime contributed importantly to Botswana's success. As a result, at the end of last year (1991), Botswana's foreign exchange reserves had risen to almost US$ 4 billion, more than those of South Africa.

While Botswana is in many respects an unusual success story, it faces most of the problems encountered elsewhere in Africa. These include the fact that: (a) economic dualism, typical of Third World economies, prevails. Seventy-six percent (76%) of the population is still rural, poor and underemployed; (b) the economy has become progressively more narrowly based and therefore vulnerable, with minerals (principally diamonds) now making up eighty-seven (87%) of exports and nearly half of GDP. The two other productive sectors, agriculture and industry, each comprise less than five percent (5%) of GNP; (c) population growth remains unacceptably high, at about 3,5% per annum; (d) despite huge investments in education and training, the economy continues to suffer from serious trained manpower deficiencies; and, (e) relative to its marked economic progress, its financial system continues to reflect severe characteristics of emerging nations and to be very sensitive to changing *realities and influences in the Southern African area.*

II. *The Evolution of the Botswana Financial System*

As is characteristic of most developing economies at a relatively early stage of their emergence, Botswana's financial system was slow to respond to the country's accelerating economic growth in the 1970's and early 1980's. It is ironic, although perhaps not altogether surprising, that foreign banks took little interest in the country until the Botswana Government in 1975 announced its intention to leave the Rand Monetary Area and subsequently introduced its own currency. Banking and Exchange Control legislation was enacted in 1976, and, shortly thereafter, the Pula was revalued, much to the chagrin of Governor De Jongh of the South African Reserve Bank who, along with the IMF, had predicted disaster for Botswana if it left the Rand Monetary Area. This turn of events is somewhat in contrast with your own experience in Lesotho, which remained in the Monetary Area but established its own Central Bank and currency in 1982 and 1979 respectively, while still retaining the Rand as legal tender.

Even then, despite mounting evidence of an economic boom, the initial reaction of commercial banks was somewhat disappointing. The two existing banks incorporated locally and only one new commercial bank was licensed under the new Financial Institutions Act. We learnt then that more banks do not necessarily mean more competition. However, as noted below, over the next ten years, Botswana's financial sector gradually broadened and deepened. It is also interesting to note that, like us, most of your own key financial institutions such as, the BEDCO, Lesotho Bank, LADB and LBFC were also established in the 1970's and that, in some respects, our respective financial structures evolved in a fairly similar manner in those earlier post-Independence years. One distinction of note between our two countries has been the significant role played by the fairly informal credit union institutions in Lesotho, which in a certain sense are financial cooperatives. By contrast, the experience of cooperatives in general in Botswana has been, at best, disappointing, even despite the creation of a specialist Cooperative Bank in 1987.

The reasons for the slow initial development of Botswana's financial sector were twofold.

First, the Bank of Botswana mistakenly discouraged the expansion of the sector by refusing to issue additional banking licences. It did so, notwithstanding the high profitability and poor service of the existing private commercial banks, in the fear that Botswana might become 'over banked'. It was not until 1987 that the Bank of Botswana changed its licensing policy, welcoming any applicant for a licence which satisfied five basic entry conditions, including adequate capitalisation, proven managerial depth and strong training capabilities. Since then, four new banks have received licences to operate in Botswana, one of them buying out the local subsidiary of BCCI. So, Botswana now has a relatively diversified banking sector, comprising six private commercial banks, of which two have British parents, two South African, one Zimbabwean and one Australian, with branches and agencies serving even quite small rural villages.

The second inhibiting factor was the Government itself. As budget surpluses mounted, the Botswana Government wisely deposited excess revenues into two special statutory funds, namely the Public Debt Service Fund and the Revenue Stabilisation Fund, which could not thereafter be used to finance normal public expenditures. The balances in these two funds increased dramatically during the late 1970s and 1980s. Government deposits with the Bank of Botswana currently exceed P4 billion, while the total deposit liabilities of the commercial banks amount to about P1,6 billion. To avert political criticism, however, the Government decided to use some of these resources to finance the local costs of the capital development programmes of parastatal corporations and development finance institutions. While eminently sensible from one perspective, the Government's action in making loans at sub-commercial rates to statutory corporations and parastatal financial institutions inevitably impinged on the activities of the private commercial banks. By the end of 1991, a total of P1,0 billion lent by commercial banks paled into insignificance compared with the P1.5 billion lent by the public sector to all local sources! The Botswana Government is thus, by far, the largest 'bank' in the country. Not only did this affect the demand for conventional bank finance, contributing to the build-up of excess liquidity in the banking system, but the incentive to introduce new financial instruments was removed from parastatals and financial institutions alike. I believe in your own case here in Lesotho, there was to some degree some manifestation of this very trend, but to a much less significant degree.

As the table overleaf indicates, there is little question that today, by all measures, Botswana's financial system is far less underdeveloped than it was say fifteen years ago. It has deepened considerably (finance ratio of 0.85 in 1977 versus 1.55 presently; monetary ratio of 0.61 in 1977 versus 1.40 presently; and monetization ratio of 0.32 in 1977 compared with 0.30 presently), comparing favourably with countries such as Trinidad and Tobago and even South Korea in this respect. It has also widened noticeably. While 25 years ago the key financial intermediaries were only two commercial banks, there are now six such banks, as already noted, two finance companies, three insurance companies, dozens of pension funds, one building society, four public financial institutions and, of course a central bank, as well as a small share market. Commensurately, new financial instruments continue to evolve, the latest being an issue of medium term Floating Rate Notes in the domestic capital market by T.A. Holdings Limited, with support from Standard Chartered and Zimbank and the launching earlier this month of Transferable Certificates of Deposit by ulc Ltd., one of two registered credit institutions or finance companies in the country.

Relatedly, a quick measure of the composition of the nation's financial system suggests a positive trend. While there was a marked dominance of the monetary or banking system over the capital markets even as late as ten years ago, there is today a much greater balance in the financial system. Non-banks and the equities market have evolved very well over the past decade, thus reducing previously noticeable evidence of market imperfections stemming from financial dualism. In this connection, a word should be said about the evolution of the Botswana Share Market, which has had a phenomenal growth path so far.

The Botswana Share Market has developed, over the first three years of its existence, in two distinct phases. The first phase, from the share market's opening in June 1989 till late 1990, was essentially characterised by trading in existing shares and by an unusually rapid rise in share values of, by some 90% over the period. Several companies undertook new rights issues. These issues were partly stimulated by a change announced in the 1991 Budget, whereby quoted public companies meeting certain requirements would benefit from reduced company tax for a period of five years. The issues also attracted substantial inflows of foreign funds from overseas investors.

THE FINANCIAL EVOLUTION OF BOTSWANA

(P million)

		End 1977	1980	1991
(a)	GNP	351	772	6 912
(b)	Broad Money Supply (M3)	111	230	2 062
(c)	Total Assets (TA):			
	- Commercial Banks	126	170	1 914
	- Botswana Savings Bank	2	3	43[6]
	- Insurance Companies[1]	4[6]	7	130[5]
	- Pension Funds	70[6]	100[6]	300[6]
	- Monetary Authority	86	267	7 747
	- BCB	1	4	65
	- BBS	5	11	232
	- ulc & FSC	2[3]	2	226
	- NDB	4	10	64[4]
	TOTAL FINANCIAL ASSETS (TFA)	224	457	10 719
(d)	Finance Ratio (TFA/GNP)	0.64	0.59	1.55
(e)	Monetary Ratio (Monetary Assets[7]/GNP)	0.61	0.57	1.40
(f)	Monetization Ratio (M3/GNP)	0.32	0.30	0.30

NOTES

1/ Includes Pension Funds for statutory bodies and others operated by IGI and BIC
2/ For 1990
3/ For 1978
4/ For 1989
5/ For June 1991
6/ Estimates
7/ Commercial Banks, Savings Bank and Monetary Authority.

In the second phase the share market index consolidated itself and rose during 1991 from about 232 to 272, a rise of just under 18%. World stock markets rose on average by 16% during 1991. Within the region, the Johannesburg Stock Exchange, however, rose by 49%, while the Zimbabwe market fell by 56% in dollar terms. The total share market capitalization in Botswana in US$ terms has risen from 63 million in June 1989 to 267 million in December 1991. Some three new issues have already been programmed to come to market in 1992. There is, however, little doubt that both from a planning and infrastructural perspective, the emergence of Botswana's share market was influenced by, and patterned after, the older and more mature exchanges in neighbouring South Africa and Zimbabwe.

Further, there is continued evidence in Botswana today, not only of an evolving inter-bank money market, but also of a greater intra-institutional involvement or 'financial layering' within the system itself. While at one level this is positive, at another level, the need for increased prudential management of the system has intensified; the larger the degree of financial layering in any economy, the more potentially vulnerable is such an economy to unexpected shocks to the financial system. Indeed, the recent nerve-racking experiences of Japan, where many banks take equity positions and place investments in the securities market, and the U.S., where the savings and loans institutions hold huge sums of mortgage assets, are clear evidence of the dangers of unmonitored or excessive intra-financial sector transactions, in as much as these are in themselves very necessary for healthy financial and economic development. Little wonder that a continuing significant feature in Botswana's financial development has been the question of prudential regulation. Recent experiences with the BCCI crisis have served to remind not only us in Botswana, but many globally, of the need for adequate supervision at all times of national and international financial systems. We in Botswana were particularly fortunate to have had the capacity in our Central Bank to adequately respond to the challenge of the potential adverse impact of the Bank of Credit and Commerce Botswana Ltd., (BCCB), as a result of the steps taken by the Bank of England in early July last against BCCI. The many lessons from this experience must not be lost. They include:

(a) the need for competent regulatory authorities;

(b) *well thought-out watertight licensing policies for financial institutions;*

(c) *the need for continued public education on financial services and facilities;*

(d) *the need to ensure the competence of supervisory authorities in the Head Office countries of possible licensees in our local financial system.*

III. *The Way Forward for Emerging Regional Financial Markets*

Against the general background of positively changing financial structures in South Africa itself, Zimbabwe, Botswana and to a lesser extent Namibia, Swaziland and Lesotho, what lessons can be learnt and what next steps can be taken to ensure the continued development of robust financial systems in our region? In my view there will be several key areas on which focus has to be sustained by emerging regional economies in the near to medium term, with significant related implications. There is no question that the already evolving regional dynamics centering, in no small degree, around developments in South Africa itself, will profoundly shape the pace, complexion and complexity of other regional financial and economic structures for a while yet to come. The key questions to be faced converge around the following:

(a) *Continued Financial Deepening*

In the cases of both Botswana and Lesotho outlined above, it has become quite evident that, while unquestionably there has been marked progress in deepening and broadening finance in these two economies, the process has only just begun, especially in the latter. Firstly, in both cases there continues to be a marked imbalance between the respective money and capital markets. This disparity manifests itself not only in the divergence between relative institutional infrastructures e.g. a greater array of bank-based institutions vis-a-vis more securities-based institutions (pension funds, insurance companies and share markets themselves), but also in the instruments available by the financial authorities in facilitating a more balanced and less dualistic development path for the financial system. In this regard, the fact that the banking and monetary systems tend to develop far earlier in all, including our own, regional financial systems, must be noted and not taken for granted. There is, *by consequence, a continued risk of what I like to call "financial asphyxiation" or a stifling by the dominant monetary system of the non-monetary system because of inherent biases in the monetary sector. Such biases include the "endowment factors" favouring banks (seignorage, greater access to information, more political clout etc.), relative to the capital market intermediaries. Thus, a future challenge for the region, especially those smaller countries, will be to ensure continued fiscal and other support for developing its long term securities markets. Botswana's recent reduction of corporate taxation rates, for five years, for those companies going public, is worthy of serious emulation elsewhere in the region. Explicit incentives for new stockbroking and dealing firms to register, for greater public issues to be made by companies and for more appropriate regulatory structures for this longer term segment of the market, must be intensified. In short, fiscal policy in this regard must not be viewed in the sterile conventional form of being merely accounting for government services, but must be viewed in a more proactive mode as supporting monetary and financial policy, with the clear aim of stimulating more activity in regional capital markets.*

Secondly, the process of financial deepening cannot be separated from the behaviour and control of inflation, neither, of course, from the mechanisms used to fight it. This is especially so in South Africa, from which there is a very high propensity for importation of goods and services by other regional economies. It should be accepted that for economies like Lesotho and Botswana, the use of the exchange rate, albeit for different reasons, will be relatively ineffective in dealing with inflation. The job will have to be done essentially by fiscal and monetary policy, depending on the relative forces fuelling such inflation. Thus, in Botswana, where domestic forces are now clearly beginning to exert much more influence on the upward trend in inflation than say five years ago, fiscal policy, especially in the quantum and nature of government spending, will presumably have to sooner or later play an actively larger role in fighting inflation than is certainly the case at present. Lesotho, by virtue of its greater financial and economic integration into the South African economy, will necessarily have to resort to a larger degree on monetary instruments, given the greater import-driven nature of inflation here. This, despite the paradox that, the very integration itself limits the likely effectiveness of independent monetary action by

Lesotho. The central point, however, is that monetary instruments such as interest rates-will have to play a key role in fighting inflation. The effort to maintain positive real interest rates has to be maintained, in recognition of the dampening effect these will be expected to exert on consumption and in attempt to coax out savings from alternative real sector assets such as cattle or other traditional forms of stores of value in our economies. While by no means the only way, this approach should in time (as is already the case thankfully in South Africa), moderate inflation. As was clearly demonstrated by a recent World Bank Study involving some 50 odd-developing countries (half in Africa), the sustained presence of positive real interest rates has consistently positively influenced the financial deepening process in the economies reviewed.

Thirdly, on this critical question of financial deepening, is the very interesting fact that in virtually all emerging economies in our region, there is a marked absence of secondary market institutions. I shall revisit this issue in discussing below the role of the public sector in our regional economies.

Fourthly, there is the question of the role of indigenous peoples in our evolving financial systems. It is interesting to note that virtually all the powerful financial institutions in South Africa today are now domestically owned, largely as a result of the disinvestment wave that hit the country starting in since 1985. By contrast, probably excepting Zimbabwe, almost all other regional economies have witnessed essentially total external ownership of the key local financial intermediaries. I have a sense that, notwithstanding the fact that the emotional propensity to indigenous ownership by financial institutions in several African countries such as Kenya, Nigeria and Zambia has had well-known disastrous effects in many cases, the South African and Zimbabwean influences could well engender agitation in this direction in other regional economies, sooner or later. This issue would have to be handled very delicately by national authorities. While the political appeal to 'indigenous' ownership of financial intermediaries as financial structures deepen could be strong, recklessness in this area could be very destabilising and disastrous for both the financial systems and their wider economies.

(b) *Financial Regulation*

In a certain sense, I consider this question the key to the continued evolution of regional economies in Southern Africa for the rest of the nineties and beyond. It is a complex question involving not only basic philosophical issues that involve, for instance, the scope of the financial system, but equally importantly, the means of doing so. Of equal or greater importance is the balancing act and inherent tension that is likely to subsist between wider economic deregulation and the much needed prudential regulation of financial systems. On the question of scope, the challenge will be the extent to which regulation of the financial system will need to take the form of an 'umbrella approach', as is being now actively considered in South Africa and, in a certain sense, as already obtains in the United Kingdom. Accepting, as we must do, that despite its second-best nature and the adverse externalities that regulation confers on the rest of our economies, regional financial systems have to continue to be closely regulated at this stage of our respective financial development, perhaps ever more so now than before.

In my view, any analysis of the importance of good financial regulation vis-a-vis wider economic deregulation must represent a call for the support of the wider financial community and not only of the important banking system. To the traditional regulatory authorities, it must be a call for the vital business of supervising and protecting the sanctity of our financial systems. It is especially a call for the major sectors mainly of our non-banking community, particularly the insurance, the pensions, and the securities industries (i.e. the share market), to recognise that Government and its state agencies alone cannot effectively discharge the onerous, but necessary, business of regulation. Regulation must be a shared activity, involving a symbiotic relationship between Government in its widest sense and industries themselves. This is why, increasingly globally, key segments of the financial systems are moving to varying forms of self-regulation with mere Government oversight, as opposed to the more traditional forms of detailed regulating of markets imposed by government authorities, usually backed by law. This evolving form of regulation *involves the regulatory authorities less in the financial systems of, by the way, not only developing countries, but even developed countries. Self-regulation by the insurance, pensions, banking, securities and other industries in the financial system, by contrast to heavy government involvement ('merit regulation'), leaves some of the responsibility for ensuring the key objectives of financial sector development, namely stability, efficiency and equity or fairness, to these consultative specialist advisory groups themselves. Such objectives are largely met through enforceable codes of ethics, rules and operating procedures and basic internal standards of accountability, as stipulated by and for the benefit of all members of such industries and sub-sectors.*

In this connection, it should be noted that, consistent with existing practices in South Africa and in industrialised economies, Botswana has recently formed a Bankers' Association, a consultative forum for the pensions industry, in addition to an existing strong body of brokers and underwriters in the insurance industry. More market-based operators, involving stock-brokers, dealers and traders for our local Stock Exchange are also required. The need for a related capital markets development authority or a securities and exchange type mechanism that oversees the securities industry, as in our neighbours such as South Africa, Zimbabwe, Kenya, and further afield in Egypt and Nigeria, does not escape Botswana's attention. This will probably also be the route other smaller emerging nations in the region will sooner or later need to take. It is the fervent hope of the Botswana authorities that these recently created and now burgeoning financial sector associations could, for example, enhance competition in their respective sub-sectors. They could, however, also assist financial systems as a whole, by the gathering of statistics on their strength, size, evolution and market profiles. Such actions would significantly help the traditional government authorities in our region in the regulation of these industries. They would also be vital at a time when severe technical manpower constraints seriously limit the effectiveness of governments region-wide as they attempt to act as regulators and when our economies are restructuring and liberalising themselves for the increasing challenges of wider regional and global competitiveness and development. In this effort of financial regulation, it is heartening to see that the recent Deposit-Taking Institutions Act formulated early in 1991 in South Africa has had an important *influence on the way we in Botswana are approaching the business of reviewing our own Financial Institutions Act currently underway. I am sure that when Lesotho and other regions begin their own future reviews, even more relevant information from the region will be at their disposal.*

(c) Financial Information

This brings me to a third critical dimension of our effort in forging continued financial development in our young regional economies. We are all aware that one reason for the need for financial regulation is the well known "asymmetry" in the information flows facing our imperfect financial markets. By this is meant the fact that some players in the markets, especially bankers, will always have more information than their customers, in a sense almost making a mockery of the principle of "caveat emptor" or "let the customer beware". Decisions in our financial markets must be based on as "perfect" a knowledge as is possible, if key stability, efficiency and equity objectives are to be maximised. In this respect, I would like to make an important point of emerging concern in Botswana, based mainly on global reactions to the recent BCCI crisis. This centers on the reliability of information from our auditing and accounting professions. Any serious effort at financial development in our individual regional economies in the future must indeed not rule out regional cooperation in this area. To our auditors and accountants, mine is effectively a plea that their profession do more to help reduce "information asymmetries" threatening our financial systems, by tightening their own professional standards of accounting and auditing in order to permit optimal decisions, not only by their own clients, but by bankers, regulators, government and all users of such services. There is no question that accounting is the nerve centre of good financial information and that financial information drives good economic decision-making ultimately. Much can be done at a regional level, given the degree of branch-banking throughout our economies, to coordinate cross border information flows and to upgrade efforts in this important area.

(d) Regional Financial Cooperation

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Finally, a word on the likely character and shape of opportunities in the short, medium and long term for regional cooperation efforts in the financial sector.

My own view is that the next year or two will witness a fundamental reshaping of wider economic cooperation efforts in the region. There is, to my mind, little likelihood of SACU surviving in its existing form, involving South Africa, Lesotho, Swaziland, Botswana and Namibia. For different reasons, intra-Customs Union tensions will 'triumph', SACU will either disintegrate or, at best, be marginalised. In this respect, a wider trading block probably centering around a PTA grouping of countries, with or without South Africa, is likely to fill the vacuum created in such a situation. Trade-driven cooperation is, therefore, likely to survive, despite the embarrassingly low level of intra-African trade now taking place, with South Africa in an axial role. SADCC, in my estimation, will survive as a grossly reshaped structure, if only for political and philosophical reasons, but with a probably more sharply defined mandate for a greater project-oriented regional development effort. It should also enhance its regional institutional and capacity building roles, becoming a useful receptacle for any subsisting flow of regional, as opposed to bi-lateral, aid. SADCC's overall effectiveness will largely revolve around its ability to quickly define clear niches for regional synergies. This should be boosted by the likelihood that a new South Africa will join this institution, if merely for, posturing purposes, or, more likely for its own self-interest of promoting a number of strong South African institutions such as the Southern African Development Bank, other financial intermediaries and those involved in technical areas.

Against this not strikingly positive real sector background, it would seem to me that the financial sector in our region offers a better prospect for cooperation than the real sector itself. Firstly, for political and other reasons of conscience, the region as a whole is expected to continue to benefit from relatively large financial flows, despite Eastern Europe. Africa, especially South Africa, still has massive untapped resources and large consumer markets. Secondly, unlike most of the rest of this continent, financial structures in the region are quite robust, financial crises are rare and institutions are generally well capitalised. Among regional countries, South Africa *and Zimbabwe already have well diversified financial structures, especially in the primary markets. One challenge will be the speed with which secondary market institutions and more wholesale products can emerge in already fiercely competitive primary and predominantly retail markets. The significance of this feature, in the main, revolves around the extent that longer term capital for development could be mobilised in our systems through more wholesale financial activity.*

Moreover, in the case of South Africa in particular, the emerging strategy of rapidly branching its financial institutions throughout the sub-region, often even in advance of strong real sector relationships, is already fairly evident. FNB and Standard Bank are already in Botswana, Namibia, Swaziland and Zimbabwe in one form or another. It is possible that the ABSA group may follow. South African insurance companies already dominate the region, as does the Johannesburg Stock Exchange, even in relation to Zimbabwe.

Rapid technological development in the financial services industry will certainly enhance opportunities for financial cooperation, as will wider global cooperation in capital adequacy and asset management benchmarks for both the banking and securities industries. Financial cooperation can, therefore, be expected to intensify in the region in the near future, with the one likely area being on the regulatory side itself. This is because the growing interrelationships of the region's financial systems are placing an increasingly mutual burden and responsibility on each of us as regulators, for the harmonisation of our now independent policies and approaches.

But, the ultimate key, in a sense, as to how fast and how far regional influences themselves will continue to shape the future financial landscape of our respective economies will be, unfortunately, governments themselves in the region. The extent to which they continue to dominate financial systems and influence financial policy; the speed with which they individually and collectively move to harmonise fiscal, exchange control policies and joint management of potentially damaging spiralling inflation, will be key determinants of the success or failure of financial integration in our region.

In a certain sense the existing Common Monetary Area is already committed to this process of deeper financial cooperation. However, Botswana's robust economy, healthy foreign reserves and increasingly liberal exchange control regimes in themselves also offer special opportunities for a unique role in moving this process forward. I thank you.

As in most cases, if not all, the macroeconomic policy environment, including monetary policy, is crucial to the evolution of financial markets in an economy. In the case of Zimbabwe, two distinct periods as regards macroeconomic policy implementation can be distinguished. The first phase refers to the pre-1990 period - the 1980s decade, while the second phase is the post-1990 period.

The pre-1990 era was characterised by an economic regime of strict controls. The economy then was highly regulated through numerous controls for instance on prices of goods, interest rates and income. Foreign exchange was rationed through a stringent allocation system. These conditions were not compatible with real economic growth as they tended to stifle investment in productive areas due to the inefficiencies they generated in the allocation of resources. As a consequence, real per capita growth stagnated during the period as the average growth in real GDP at about 3% per annum was matched with that of the population. The decline in investment arising largely from both the foreign exchange unavailability and the resultant constraints on supply led to rising unemployment and engendered inflationary pressures in the economy.

It is important to note that, the financial sector was not spared from the regime of controls. The operations of the financial organisations were regulated through various statutory instruments. Entry in the markets by new institutions was strictly controlled and so were the activities of the existing institutions. Both deposit and lending rates of the various institutions were fixed and rarely varied to reflect liquidity conditions in the markets. It was therefore not surprising that, with the rising inflation rate, most of them were negative. The controls on rates coupled with controls on prices and incomes rendered the implementation of an active monetary policy to mobilise savings and contain inflation unnecessary. In addition, the financial markets so encumbered with controls could not effectively operate as a conduit for savings towards productive investment and were highly segmented.

The costs that such a highly controlled system entailed in terms of price inflation and unemployment prompted government to reconsider its macroeconomic policies. Hence, late in 1990, it embarked on a 5 year economic structural adjustment programme (ESAP). Unlike the pre-1990 era, ESAP entails a gradual shift towards market forces in all sectors. ESAP puts accent on the following key components : trade liberalisation, deregulation, fiscal reform, monetary policy and financial reform and investment promotion. An elaboration of some of these areas would be necessary in order to have a clearer understanding of the nature of financial markets that are envisaged to evolve under the liberal macroeconomic environment.

Under ESAP, economic growth emanates from investment promotion especially in exports. In order to do so, this requires that the allocation of both financial and human resources in the economy be done as efficiently as possible and this means a gradual move towards market forces. To achieve this, the deregulation and decontrol of the various economy's sectors is of paramount importance.

On the fiscal front, government will progressively reduce its deficit from about 10% of GDP (average of the 1980-1989 period) to 5% by 1994/95. This will release funds largely absorbed in the less productive recurrent expenditures towards productive investment. Trade liberalisation, on the other hand, implies the eventual abandonment of foreign exchange allocations through the gradual placing of goods, initially raw materials, onto Open General Import Licence (OGIL). These measures have to be synchronised with those on monetary policy and financial reform if the objectives of ESAP are to be fully realised.

On the financial front, monetary policy will become more active and less accommodative as in the past. Interest rates will be determined in the market and the monetary authorities will only influence them via Open Market

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Operations (OMO) as the major tool of policy. To encourage investment, monetary policy will be more active in pursuit of its objectives of mobilising surplus resources in the economy and channelling them towards investment while at the same time curtaining inflationary pressures that characteristically accompany the reform programme during the early stages.

For monetary policy to attain its objectives as described above, efficient and well developed financial markets become of utmost importance. The more developed the financial markets in terms of depth and instruments, the more responsive the economy will be to macroeconomic policy thus enabling the policy makers to direct it towards the desired goals in the case of Zimbabwe, sustained real economic growth and employment creation.

Zimbabwe, relatively speaking, has fairly sophisticated and well diversified financial markets. It boasts nine commercial banks, a Post Office Savings Bank (POSB) with more than 140 branches, 3 building societies, 3 finance houses, 3 discount houses, development institutions, numerous pension funds, unit trusts and over 50 insurance companies. These are well specialised institutions ranging in operations from the short to the long end of the money and capital markets. Central to the money market are the three discount houses whose major function is to act as repositories for short term call deposits and through their privileged access to the central bank as lender of last resort ensure that liquidity is available in the financial system.

At the long end of the capital market are the development institutions and the stock exchange. These provide loans for investment in the productive sectors particularly mining, agriculture and manufacturing. Commercial banks, on the other hand, while also providing short term loans for instance for working capital to companies, they are also into long term financing. Merchant banks provide largely trade-related financing and this is done primarily through bills of exchange or bankers acceptances. The insurance companies and pension funds as well as the POSB are also into long term financing with a great proportion (over 50%) of their portfolios invested in government stocks. The finance houses are mainly into machinery, plant and equipment financing as well as factoring and leasing. Building societies finance mostly residential properties but also extend loans for industrial and commercial properties.

The stock exchange is at the core of the capital market and through primary issues, it enables companies to raise capital for long term project financing. Both the secondary and primary markets for equity provide an important investment vehicle for both institutional investors and households . Activity on the stock exchange, however, in the past has been low key due to a number of factors among them the prevalence of family based enterprises that rely largely on own resources for expansion and lack of adequate incentives and knowledge of its operations especially among the majority of the household investors. Recent developments point to a definite upturn in activity as several primary issues over the past 12 months have generally been well received by the market with some being oversubscribed several times over. Because of the fixed yield curve that overtime has become unattractive to investors, a small volume of government stocks was traded on the stock exchange. But with the envisaged financial reforms under ESAP, this situation is expected to change. Already stocks are being issued on a tender basis and thus the market now determines their yield.

Development institutions are largely a phenomenon of the post-independence era, a reflection of a reorientation in government policy. Most of them were set up at the instigation and assistance of government and were targeted at specific sectors of the economy which hitherto were disadvantaged in various ways in accessing investment funds at the established institutions. In other words, the setting up of these institutions was largely motivated by the need to eradicate the inequities of the past regimes that focused on minority groups to the exclusion of the majority indigenous people most of them in small scale enterprises. Thus, in recognition of this, the advent of independence in 1980 ushered in new institutions among them the Small Enterprises Development Corporation (SEDCO), established in 1984 and the Zimbabwe Development Bank (1983). Existing organisations such as the Credit Guarantee Scheme which has operated since 1978 targeted at small businesses, mostly rural traders, were reorganised and strengthened to reflect the new thinking. In 1991, a new institution, the Venture Capital Company of Zimbabwe (VCCZ) was launched. The main function of the VCCZ , which has the small-to medium-term enterprises as the area of focus, is to provide long term seed or trigger capital for investment projects for periods of five to seven years.

As mentioned before, the economic reform programme now underway in Zimbabwe aims at generating investmentled growth of about 5% per annum. With the accent on investment, there is therefore need to ensure that local resources are available to meet the anticipated demand for investment funds. Hence, the financial system has to evolve to accommodate these changes. As the adjustment programme entails a movement towards market forces, it is imperative that the financial sector also move in that direction. Already, in order to mould a more efficient financial system and to encourage competition among institutions, and therefore allow greater mobilisation of savings, new institutions are being introduced into the system. Besides the VCCZ already mentioned, a discount house has also been set up, approvals for a building society and a merchant bank have been given and various applications are also being considered. Additionally, the present high level of segmentation will have to be diluted to allow for increased competition. Parallel to these changes, the shift towards

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a more market-oriented application of monetary policy to regulate interest rates and liquidity in the economy makes the deregulation and removal of controls on the operations of financial institutions an imperative. Already rates of interest for both deposits and loans have been significantly decontrolled.

To conclude, it is important that financial markets be developed so as to adapt to the changing environments and ultimately become more efficient instruments of fostering development. This has been a major guiding principle for financial reforms under Zimbabwe's structural adjustment programme. To facilitate this, a new legislation will soon be put in place which will provide the legal foundation for the emergence of new market instruments and financial services. The stock exchange is being developed and necessary incentives are to be provided to allow for a broad based participation by individuals, companies and other investors. By 1995, with a strong supervisory machinery in place, there will be free entry by institutions into the financial system. All these changes will ensure that the financial system develops in tandem with other sectors in the economy. This is crucial for the success of the structural adjustment programme.

C E N T R A L   B A N K   O F   L E S O T H O

MONETARY POLICY AND ITS ROLE IN THE DEVELOPMENT OF FINANCIAL MARKETS IN LESOTHO

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SEMINAR ON FINANCIAL MARKETS
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I. Introduction:

Since the emergence of the debt crises in the early 1980s, many developing countries are restructuring their economies towards free market oriented systems. In most cases the economic reform programmes are financially supported through the IMF Structural Adjustment Facility (SAF) where the IMF and the World Bank jointly formulate programmes that support their lending. The thrust of these programmes is often to improve the country's balance of payments position and sustenance of economic growth.

The main policy instruments often employed by countries in their adjustment programmes are, fiscal policy, commercial policy, monetary policy and the exchange rate policy. The purpose of this paper is to look at the macroeconomic role played by monetary policy with special emphasis on the development of financial markets in a developing country like Lesotho. Lesotho, unlike most developing countries did not have a debt problem. However, it decided to restructure its economy within the IMF/World Bank framework because of its fragile external position and poor resource base.

Among the issues which feature prominently in Lesotho's Structural Adjustment Programme is the development of an efficient financial system both in size and diversity. It is this desideratum that has brought the role of the Central Bank of Lesotho to the fore in the reform process. To be able to achieve this objective the Central Bank of Lesotho has realised that it must have in place an aggressive monetary policy that will facilitate production, trade and encourage saving through development of diversified financial assets. It has often been argued that access to a variety of financial instruments enables economic agents to pool, price and trade risk. Trade, the efficient use of resources, saving and risk-taking are the cornerstones of a growing economy[1].

In order to put the role of the monetary policy in its proper perspective, the paper first examines its conceptual framework. Secondly, it looks at the practical role played by monetary policy in the context of Lesotho's structural adjustment programme towards the development of financial markets.

II The Conceptual Framework:

Definition of monetary policy

1. Monetary policy is often differently defined depending on how it is being applied. In more developed countries the main objective of monetary policy is to maintain price stability. In developing countries where the playing field for monetary policy to operate efficiently is often not level, governments and central banks have taken a deliberate effort to extend the role of monetary policy into that of establishing new institutions in order to promote overall economic development. In other words,

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1) World Development Report 1989 p.1

monetary policy in developing countries is expected to be more proactive than reactive. Whereas in developed countries financial development has been demand-led, in developing countries it is supply-led and this forms a major departure point when it comes to the application of monetary policy in the latter countries.

Instruments of monetary policy

2. Whether it be in the short or long-term it is now being generally accepted that money plays an important role in economic development. It has also now been accepted that money forms part of national wealth which competes with capital accumulation. Since money on its own is not "productive" it is usually deemed necessary to create an enabling environment for money to be transformed into physical capital that will directly contribute to output growth. This is where monetary policy plays its part. There are five policy instruments which have traditionally been employed in order to implement monetary policy - (1) expanding or contracting the money supply through open market operations; (2) prescribing liquidity reserve ratios to commercial banks in order to ensure adequate protection of the interests of depositors and to control the reserve base of banks for the purpose of regulating their lending capacity; (3) lowering interest rates through ceilings and imposing credit controls; (4) varying the discount or bank rate in order to influence the market rate of interest and (5) persuading commercial banks through moral suasion to channel funds to the productive sectors.

The need for monetary policy hence the need for establishment of central banks, has been brought about by the fact that left on their own, financial markets may not necessarily lead to the most socially desirable outcomes. This need is even more accentuated in developing countries like Lesotho where basic institutional structures that facilitate a better flow of the much needed information are either poorly developed or non-existent. The absence of well-developed financial structures has rendered it difficult for many developing countries to effectively implement their monetary policies. Consequently, the efficacy of the five policy instruments mentioned above has been severely limited.

Limitations to open market operations as monetary instrument

3. Open market operations which is a major policy tool for the control of money supply in developed countries can hardly be applied in developing countries in the absence of well developed financial markets. This view is well captured in the following excerpt from the Reserve bank of India's Report of the Committee to Review the Working of the Monetary System: "Open market operations are conducted by a central bank mainly with a view to directly or indirectly affect the reserves of banks and thereby the extent of monetary expansion and in the process to create and maintain a desired pattern of yield on government securities and generally to help the government raise resources from the capital market. Thus, this policy instrument has two aspects viz. the monetary policy aspect and the fiscal aspect. For the conduct of open market operations as a monetary instrument, the market for government securities should be well organised, broad-based and deep, so that the central bank is in a position to sell and

buy securities to the extent it considers desirable..... . Since these conditions are not met by the Indian capital market, open market operations are of minor importance as a monetary instrument though they serve as an adjunct of fiscal policy in India to some extent."

Liquid reserve ratios and their problems

4. Although liquidity reserve ratios are commonly used in developing countries, they have only been effective in respect of ensuring adequate protection of the interests of depositors or in other words, enhancing the confidence of depositors in the financial institutions. As a tool for regulating the lending capacity of commercial banks its role has been rather circumscribed. The ineffectiveness of this policy instrument is largely ascribed to the prevalent liquidity of commercial banks in developing countries which as Mohammed[2] argues, could be due to the fact that most commercial banks' lending capacity does not only depend on deposits from the public. Commercial banks, he points out, receive a lot of income from rents, commission, interest on securities etc, all of which constitute effective source of investible funds. In the case of foreign commercial banks, they can also obtain funding from their parent banks abroad.

The discount rate

5. In a similar vein the efficacy of the discount rate or the bank rate is also circumscribed by the excess liquidity of commercial banks together with the small size of the commercial banking system and the very narrow financial markets.

Prescriptive interest rates and credit controls

6. All the above three policy instruments could be called the indirect tools of monetary policy. According to Lindgren[3] indirect instruments seek to control interest rates and banks' capacity to attract deposits and extend credit indirectly by influencing liquidity conditions and interest rates more generally. In contrast, direct controls seek to control amount of money and credit or levels of interest rates directly. Due to the inherent rigidities of financial markets in most developing countries, central banks usually resort to direct controls. The most commonly used form of direct control is the prescription of quantitative limits on bank credit to the public. Another form of direct control, though mild, is moral suasion. With moral suasion central banks attempt to influence commercial banks activities through informal persuasive methods. However, moral suasion can only be effective where there exists good

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2) A. Mohammed: Theoretical Basis of Monetary Policy in Africa - in <u>Monetary Theory and Policy in Africa</u> ACMS Dakar 1981 P.57

3) Carl-Johan Lindgren - The Transition from Direct to Indirect Instruments of Monetary Policy - in <u>The evolving Role of Central Banks</u> IMF 1991 P309

relationship, mutual respect, cooperation and professional discipline between the central bank and the rest of the banking system.

7. The analytical underpinnings of the IMF/World Bank adjustment programmes are based on the free market paradigm. As a result, the ubiquitous direct controls employed by many developing countries are strongly discredited and held responsible for the also prevalent financial repression which has stifled those countries' potential of economic growth. It is often argued that direct controls can be an effective monetary policy instrument but only in the short-run. However, they have been popular and used on a long-term basis in developing countries because (1) they are relatively easy to use; (2) they are easy to link to a monetary programming format and to monitor and (3) they are easy to explain to politicians and to the public. The costs outweigh the benefits notwithstanding. Lindgren[4] succinctly delineates the problems associated with direct controls as follows:

- they are inflexible and ineffective as they are hard to fine-tune and only apply to certain segments of the system;

- they discourage savings mobilization and thus total credit availability in the economy;

Limitations of direct controls

- they cause disintermediation from the organised (controlled) financial sector to unofficial domestic markets or foreign markets (capital flights);

- they limit competition among banks to historic market shares due to the need for bank-specific ceilings and lack of price; they do not foster competition for new deposits and lending opportunities;

- they hinder price competition and the development of financial markets;

- they require the central bank to become increasingly involved in micromanagement issues related to individual banks, which often conflicts with its macroeconomic role;

- they make the determination of the levels of credit and interest rates appear as a political decision and, therefore, prone to political rather than monetary considerations.

8. In contrast, indirect controls are argued to be impersonal, impartial and hence allowing a more transparent and responsive price system that is essential for an optimal allocation of resources. Their advantages are as follows:

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4) Ibid. p.232

- they ensure automatic and immediate adjustment, and, therefore, reduce the risk for policy error;

- they transmit the policy signals and effects immediately to all segments of the economy;

- they assure an optimal allocation of money and credit based on price and relative risk return;

- they ensure consistency between monetary, fiscal and exchange rate policies;

- they make pressures in the financial markets immediately apparent;

Advantages of indirect controls

- they support and complement exchange rate management;

- they reduce the political sensitivity to interest rate change; and

- they allow the central bank to stand back from the market without losing control.

9. While it is clear that indirect controls could have an edge on direct ones, it is also clear that they cannot operate in a vacuum. The necessary and also sufficient condition for their successful application is the existence of an appropriate institutional framework in the form of diversified and competitive financial markets. In the absence of such an environment, monetary policy in the traditional sense is bound to be of limited value. It has since then dawned to developing countries that monetary policy does not necessarily have to be employed in the same manner as in developed countries, i.e. for stabilization purposes. The emphasis now is on development. This variant of monetary policy is well captured by Frimpong-Ansah in the following statement - "a primary objective of monetary policy in development is to provide a stable economic environment, and the institutional framework for mobilization of capital for economic growth."[5]

Intervention towards liberilization

10 This challenge means that central banks in developing countries certainly have to play an interventionist role. However, that role should be geared towards a creation of an enabling environment that will eventually pave the way for central banks to stand back while not necessarily losing control. The interventionist role meant here is that which will ensure that the dualistic nature of financial markets in developing countries is brought to an end. By dualistic financial markets it is meant the unorganised financial market (rural) and the organised financial market (urban). It is a well documented fact

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5) J.H. Frimpong-Ansah: Monetary Policy and Development- in Monetary Theory and Policy in Africa ACMS Dakar 1981 P.233

that this dichotomous setup is a product of the colonial past. Unfortunately, upon the acquisition of their political independence, most developing countries have not been able to merge the two together. Notwithstanding the endeavours to bridge the gap, the unorganised markets remain marginalised while the organised sector continues to flourish. The most vexing observation is that while the traditional sector in which the majority of the population live remains financially neglected, it is largely commerce other than production in which the bulk of financial resources are spent in the urban sector.

11. It is my strong belief that this seminar is about reversing this situation through the application of appropriate monetary policies that will enable a more human-centred development whose objective will be to strive for optimal use of all the country's resources.

The following section examines the role of monetary policy in Lesotho within the framework of the IMF/World Bank supported structural adjustment programme against the background of the above theoretical framework.

II Monetary Policy in Lesotho

12. Lesotho's monetary policy at the present moment centres around the following objectives:

Objectives of monetary policy

(i) price stability;

(ii) the improvement of the balance of payments position;

(iii) restriction of domestic credit to a rate compatible with the economy's nominal rate of growth;

(iv) the encouragement of commercial banks to channel more financial resources into productive investment so as to support the planned increase in productive capacity;

(v) the promotion of investment; and

(vi) the improvement of industrial access to capital markets.

With the exception of (i), (ii) and (iii) it is clear that Lesotho's monetary policy strives to provide an institutional framework for mobilization of capital for economic growth and development. The first three objectives are aimed at the stabilization of the economy.

13. Prior to the launch of the structural adjustment programme in 1988/89, Lesotho's monetary policy was showing obvious weaknesses in so far as (i) the country's balance of payments position was deteriorating continuously and (ii) domestic credit was expanding at an unsustainable rate, especially credit to the

public sector. In addition, apart from performing its conventional banking duties as a watchdog of the banking system, the Central Bank of Lesotho (CBL) did not seem to have an explicit or formal policy relating to domestic mobilisation of development finance. This could have been due to the fact that it was still a fledgling with hardly ten years in operation.

Credit control policy

14. As one of its first moves towards arresting the phenomenal expansion of domestic credit as well as to improve the country's external balance position, the CBL imposed credit ceilings on bank loans. These credit ceilings applied to the three main commercial banks in the country while two financial institutions were exempted by virtue of their operations being more development-oriented. No sectoral sub-ceilings were established but the CBL continued to encourage the banks to direct more credit to the productive sectors. The imposition of the credit ceilings was not only for the purpose of correcting macroeconomic imbalances as its other objective was to reduce bank borrowing by government in order to release more funds to the productive sectors. It has always been the view of the CBL that excessive borrowing by the government can crowd-out the more productive private sector. To this end, during the period from 1989/90 to date, government indebtedness to the banking system has been reduced significantly and a substantial amount of loanable funds released to the private sector as shown in table 1 below.

Table 1

DOMESTIC CREDIT
Maloti Million; end of period

	1988	1989	1990	1991
Private sector	136.0	161.9	193.8	258.5
Statutory bodies	24.0	24.6	26.2	35.9
Government (net)	245.8	302.9	206.6	111.0
Total	405.7	489.4	403.2	405.4

15. Although Table 1 shows clearly the falling growth of domestic credit and the redirection of credit from government to the private sector, it does not, however, show sectoral distribution. Traditionally, bank credit in Lesotho has been dominated by distributive services whose value-added is relatively low. However, since the institution of the structural adjustment programme, this trend has been, to some extent, successfully reversed. As shown in Table 2, credit to distributive services has, in per cent of total credit to business enterprises, stagnated around 33.0 per cent since 1989 while that of manufacturing has increased its share from 7.0 per cent in 1989 to 12.0 per cent in 1991. Indeed, this has been a commendable performance if it could only be sustained.

Table 2

SECTORAL DISTRIBUTION OF CREDIT
Maloti million; end of period

	1989 Amount	%	1990 Amount	%	1991 Amount	%
Mining	0.1	-	0.1	-	0.2	-
Manufacturing	9.0	7	15.4	9	26.2	12
Construction	26.2	19	30.2	18	41.2	18
Other Development sectors	34.4	25	33.5	19	43.5	19
Distributive services	46.1	33	58.9	34	76.3	33
Other services	21.7	16	34.3	20	41.0	18
Total	137.5	100	172.4	100	228.4	100

16. Notwithstanding the disadvantages of direct credit controls mentioned in section 1, the CBL is aware that the current controls can only serve a good purpose in the short to medium-term, hence the exigent need for more organised, broad-based and deep financial markets.

Interest rate policy

17. Besides credit controls, which as mentioned above is a recent phenomenon, the CBL has traditionally been using the interest rate as its main instrument of monetary policy. The main objectives behind Lesotho's interest policy during the structural adjustment programme are (i) to maintain positive real interest rates so as to encourage saving and (ii) to ensure that the movements in Lesotho's interest rates are in line with the South African ones because of close integration between the two financial systems, a common exchange rate and the possible capital flight.

Negative real interest rates

18. In as far as the first objective is concerned success has, to say the least, been partial. This has been so because of the inability of the authorities to contain the inflation rate. The bulk of Lesotho's inflation is imported from the rest of the Common Monetary Area (CMA) region and hence out of control of the local authorities alone. As shown in table 3 and chart 1, below, interest rates, with the exception of CBL rates, have been below the rate of inflation during the structural adjustment period. It was only during the last quarter of 1990 when it fell to a low of 9.1 per cent that all real interest rates were positive. This development was largely a result of a similar, though independent, macroeconomic policy stance taken by the CMA countries against inflation. It did not last until 1991 when at the end of that year inflation rose steeply to 19.5 per cent both due to extraneous and internal factors. Among the

internal factors could be mentioned a precipituous civil service wage bill increase of 42.0 per cent, the continuing price-distorting import controls for the protection of some food producing industries and the ever increasing tariffs on utilities levied by some parastatals for cost-recovery. There is a general feeling that the utilities price increases are more of inefficiency tax on the consumer by the parastatals because it is easier to increase tariffs than improve efficiency in a monopoly situation.

Table 3

INTEREST RATES AND INFLATION IN LESOTHO
in percent per annum, end of period

	1988	1989	1990	1991
Central Bank				
Call rate	13.50	16.75	16.75	15.25
31-day	14.25	17.25	17.25	15.50
Commercial Banks				
31-day	10.50	12.00	12.00	12.50
1-year	12.00	13.00	13.00	13.00
Savings Dep.	12.50	15.50	15.50	13.00
Prime lending	17.00	20.00	20.00	20.00
Inflation	14.00	14.30	9.10	19.50

Source: CBL

In short therefore, it could be concluded that positive real interest rates in Lesotho have been undermined, to a large extent, by the incessant problem of inflation.

Financial market imperfections

19. With regard to the second objective, the Lesotho monetary authorities have been successful in maintaining the local rates in line to those prevailing in South Africa. Although the fixed exchange rate and open capital markets in the CMA region could have made interest rate an easy policy instrument through some quick adjustment mechanism, it has however, not been the case due to the oligopolistic nature of Lesotho's banking system. As a result, the CBL officially sets the prime lending rate, the minimum savings deposit rate and the rates on banks' deposits at the CBL. Although Lesotho's deposit rates remain below those of South Africa, with the exception of savings deposit rate, the differential is not as large as could have otherwise been without the official intervention. For their part, commercial banks complain that their adminstration costs are high and as a result, they have to maintain deposit and lending rates differentials at the level that will keep them in business. That administration costs are high could be true in view of the small size of the banking system in Lesotho. However, the profitability of the commercial banks is still comfortably high.

JUMP STARTING THE PROCESS OF FINANCIAL MARKETS DEVELOPMENT IN LESOTHO

1. INTRODUCTION:

For the last three years there has been relatively low saving globally. Economies of most developed industrial countries have been facing a recession. Traditional donor countries are increasingly becoming more inward looking due to domestic socio-economic problems. Keen interest in the socio-political and economic transformation of former socialist countries in central and eastern Europe appears to have dampened enthusiasm about Africa. After about a decade-and-a-half of adverse international economic environment and internal economic setbacks due largely to mismanagement, donor fatigue has set in. Assistance is now relatively more limited and conditional upon commitment to effecting certain stated reforms. Times have changed. In the circumstances, striving towards self-reliance in many respects should reasonably be quick and resolute. Such a move requires, among other things, a comprehensive and efficient machinery for mobilising domestic savings, containing leakage of financial resources and allocating and applying them effectively to the productive activities in the economy. With comprehensive and efficient financial markets, other aspects of the economy responding positively, a strong and sustained real growth would be possible.

There is scope and need for improved realisation of the potential in the mobilisation of domestic financial resources and their efficient allocation to productive sectors in the economy. There is room for developing the financial markets further in African economies. Lesotho is no exception.

This paper reviews the evolution of informal and formal financial infrastructure with a view to identifying the key weaknesses and creating a conducive environment to deepen financial markets.

2. HISTORICAL BACKGROUND : LESOTHO'S FINANCIAL MARKETS:

(a) Informal and semi-formal small scale operations:

The concept of accumulating resources and making some of them available to others for use (that is, some form of saving and lending) was not entirely new among the Basotho. Wealth was largely accumulated in the form of livestock. It was lent to others for use through the "Mafisa" system. In fact the Sesotho word for <u>interest</u>, be it on deposits or lending, is "Tsoala" or offspring. Unused arable land has been loaned out through "Seahlolo" a version of <u>sharecropping</u>.

Even with the monetisation of the economy the practice of borrowing and lending among relatives, friends and neighbours continues. Usually no interest is charged and no collateral is required. One may volunteer to return a favour in one form of another as a sign of gratitude.

With the passage of time new methods of mobilising financial resources and making them available for use at an informal level were developed. Clubs were formed and organised "setokofele" in turns, proceeds are either shared equally by members each time or put in a common account at the bank or they are allotted to members in turns. The latter approach ensures that each member gets a lump sum periodically for own use. The "Setokofele" approach has been particularly successful among the black population of South Africa.

Rotating savings and credit associations (ROSCAs) have been in evidence in Lesotho. Association members contribute a specified amount of money at agreed intervals into a pool. The pool money is allocated to a member following an agreed sequence.

High burial expenses brought about burial societies commonly known as "Mpate Sheleng". Although at present these societies are highly specialised, one sees the potential of their diversifying their objectives. Accumulated funds can be used for productive purposes as well.

In some villages households have organised themselves and contributed to a fund for a village project. Sometimes such funds are used as counterpart contribution in the case where the government or some external donor finances part of the project.

Attention now turns to semi-formal and small scale formal operations. They are cooperative societies, cooperative credit unions, money lending and traders.

Cooperative societies movement has a long history in Lesotho, both consumer and producer cooperatives. Producer cooperative societies assist members in securing inputs and in marketing products. However, cooperative societies movement has had a sad history of fraud, corruption and mismanagement. Its success has been limited. The confidence which members of the public have in it has been dented. Cooperatives Credit Unions (CCUs) were a result of the work of the Extension Department of Pius XII University College in collaboration with CUNA International in the late 1950s and very early 1960s. By 1969 there were 40 CCUs with a total membership of 12,116. By 1988 they were 73 (that is about one credit union for every 4657 households in Lesotho) with a membership of 30000 (that was about 9 per cent of households in Lesotho). An apex body, the Lesotho Cooperative Credit Union League was formed in 1967. This machinery has also been used to channel credit of targeted schemes from time to time. That has not necessarily been to its long term benefit as those funds are often disbursed under conditions not conducive to the mode of operation, aims and objectives of CCUs. The movement grew well up to 1970s. Then party political frictions adversely affected it. Subsequently, it became difficult to recover. Membership became dominated by mature women (50 and over) many of whom were widowed. Borrowed funds were often used for provident and consumption purposes. That made repayment difficult as most members were very poor. The movement needs an overhaul and a boost.

Some traders have traditionally sold their merchandise on credit to promote sales and lock-in customers. Hire purchase of durable consumer products has also been common in Lesotho. Because of the common monetary area arrangements even firms in South Africa have extended this type of facilities to customers in Lesotho.

Money lending on a commercial scale business is relatively new in Lesotho. It grew rapidly when domestic credit was curbed in Lesotho, particularly credit to households, under the Structural Adjustment Programme. This was exacerbated by the tightening of credit in South Africa which included hire-purchase, with the objective of controlling inflation. It is not clear what direction this activity will take when credit restrictions are eased and access to financial institutions becomes easier.

Institutions such as village banks, money keepers and unit rural banks, found elsewhere in Africa, are not in evidence in Lesotho.

These informal, semi-formal and small scale entities will continue to function if access to the formal institutions remain limited for low income groups.

(b) Formal financial markets:

South Africa Post Savings Bank operated in Basutoland using post office network in the country. In 1966 the operation was taken over by the Lesotho Post Office. In 1972 when Lesotho Bank commenced operation Post Office Savings Bank operations stopped. Lesotho Bank took a commercial bank bias and developed very quickly and is now by far the largest bank in Lesotho.

Basutoland Cooperative Banking Union (BCBU) was established in 1957. It served independent marketing cooperative societies. They were very successful then. Due to lack of expertise of its management the Bank faced difficulties and was liquidated in 1963.

Basutoland Cooperative Savings Society (BCSS) was established in 1959. It became Lesotho Cooperative Savings Society in 1966. It focused on financing housing when demand for modern housing rose as a new middle-class emerged. It flourished for a short while and due to lack of qualified management and staff coupled with abuse it eventually collapsed. It was liquidated in 1981. When it became obvious that LCSS was ailing, in 1976 the Lesotho Building Finance Corporation was founded. It started operations in 1977. It has been confined to financing of housing. LBFC had an unhappy early history of mismanagement and abuse. It was rescued and turned around in the second half of the 1980s. It has now been making marginal profits.

Standard Bank, a British commercial bank, started operation in Lesotho in 1902. It became Standard Chartered Bank in 1977 when it merged with the Chartered Bank which until then served mainly the Asia. Barclays came to Lesotho in 1957.

Commercial banks and the Post Office Savings Bank were seen as mobilising savings in Lesotho and transferring those funds to finance development in South Africa and were paying extremely low interest rates on deposits. The founding of Lesotho Bank was partially to counter this phenomenon. In formulating the Financial Institutions Act (1973) a provision was made under section 21, which gave the Minister of Finance power to regulate assets which banks could hold outside Lesotho. This power was not invoked until 1981 by Legal Notice No.81 when minimum local assets requirements were set at 85 per cent.

Lesotho Agricultural Development Bank (LADB) was founded in 1975 and started operation in 1976. It was established for the purpose of financing agriculture. For much of its history it suffered ailments common to development banks in Africa. Since 1989 LADB expanded its branch and agency network rapidly incurring high operating costs and maintaining low loan recovery. The expanded capacity has tended not to be fully utilised.

Lesotho National Development Corporation (LNDC) was established in 1967 to "... initiate, promote and facilitate the development of manufacturing and processing industries, mining and commerce..." (LNDC Act 1967). In the absence of a development bank then, LNDC, as one of the means of fulfilling its mandate, has had to extend some loans to enterprises in need of additional finance. Sources of funds used for this purpose were largely government subventions and external grants and concessional loans or lines of credit.

In 1975 Basotho Enterprises Development Corporation (BEDCO) was formed as a subsidiary of LNDC. BEDCO was meant to assist aspiring Basotho entrepreneurs by way of loans, shelter, training and extension services. In 1980 BEDCO became a separate parastatal. Loan recovery became a major problem. Donor funding was eventually withdrawn. BEDCO's mandate has had to be rationalised. The lending function has ceased.

Regarding leasing services WMN Investments provides the service but only to a limited extend and to a limited clientele. Caledon, which used to render comparable services, has been phased out.

Legislation to establish Lesotho Monetary Authority was adopted in 1978. Lesotho Monetary Authority commenced operations in 1980. In 1982 it was elevated to the level of the Central Bank.

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There are now three commercial banks in Lesotho, namely Barclays, Lesotho Bank and Standard Chartered Bank. There is the Lesotho Agricultural Development Bank which caters for agriculture but is attempting to diversify by going into commercial operations. Lesotho Building Finance Corporation is continuing with its mandate of financing housing. Lesotho National Development Corporation is the only development finance institution. This essentially forms Lesotho's formal financial institutions infrastructure.

Perhaps it is in order to mention, albeit in passing, insurance companies. They accumulate funds through premiums. Such funds are normally invested in productive activities in other countries and thus contribute to their real economic growth. In Lesotho there are the Lesotho National Insurance Company (LNIC), IGI, both offering a variety of products. Metropolitan offers mainly life assurance. Minet Kingsway is one of the major brokers. There are numerous other brokers, some doing business for foreign companies. Many Basotho hold life assurance policy contracts with South African companies. Premiums paid periodically represent massive leakage of funds from Lesotho. There are also some provident and pension funds invested with South African companies. They thus contribute to the development of the South African economy and to that of Lesotho. A way has to be found of using these accumulated funds in the development of Lesotho's economy.

3. LESOTHO COMPARED TO SELECTED SADCC COUNTRIES:

Regarding the number and variety of financial institutions, Table 1 shows that there are three commercial banks in Lesotho compared to four in Botswana and six in Swaziland in 1990/91. They have increased to six in Botswana in the meantime. With the exception of development banks which often require improved management and have a tendency to drain public funds in order to restore eroded capital, most of the rest of these institutions are financially sound and reasonably adhere to set prudential practices.

While numbers may roughly indicate the degree of competition, it does not say much about distribution of branch and agency network vis-a-vis population and commercial activity distribution. That is, accessibility is not revealed. Attending to that would form a separate exercise.

Table 2 indicates that in each of the BLS countries commercial banks have mobilised sizeable deposits which form financial resources that can be used not only in the expansion of productive capacity of the economy but also in the servicing of such expanded capacity. The potential in this regard is not fully realised. More deposits can still be mobilised (a) through improved but measured accessibility, and (b) by offering relatively more attractive rates on deposits. If deposits held by other deposit taking institutions were included, the magnitude would of course be even higher.

As shown in Table 2 there is excess liquidity in all BLS countries. High figures of excess liquidity for 1986 and 1987 in the case of Swaziland, and 1988 and 1989 in the case of Botswana, can be explained largely in terms of export performance. Excess liquidity figures are highest in Lesotho. Exceptionally high figures for 1988 and 1989 can partially be attributed to tight monetary policy applied at the time. Tight monetary policy aside, an expert from abroad once described Lesotho's commercial banks as being (a) well managed, (b) adequately capitalised, (c) limited in number, (d) operated in a highly segmented markets (each serving a particular segment), (e) guided by fairly conservative standards in their credit risk appraisals and (f) adhere to short-term maturities in their loan portfolios. The last two points are considered to be underlying limited range of eligible borrowers to established companies, well capitalised companies and to individuals with high net worth. Some business leaders have complained about the limited range of products (=types of services) offered by the Lesotho banks.

Banks have pointed out that bankable projects are scarce and that generally default rate is on the high side and that contract enforcement by the judicial system is ineffective. All these combine to make aggressive lending risky. Others retorted by pointing out that banks operating in developing countries should not be passive and expect well prepared project documents upon submission of applications for loans. It is argued that there should be guidance. Applicants ought to be assisted in crystallising their ideas, in planning and drawing up of projects. Some banks point out that such involvement with borrowers could be used against the lending bank later on by defaulting borrowers. That is, banks could be considered to be party to a failed venture.

Lesotho Bank has been experimenting with a projects division or unit. The division is introducing an element of term lending (which is not common with commercial banks). It also seeks to assist applicants in drawing up projects properly. The division itself intends to generate project ideas which could be offered to potential borrowers. To minimise defaults the idea is to provide extension services to guide borrowers in the prudent use of loaned funds. If fully implemented it would be of great interest to assess its results.

In Lesotho there are a number of organisations that offer guidance to Basotho entrepreneurs in securing and using borrowed funds. They are the Basotho Enterprise Development Corporation (BEDCO), Business Training Centre (BTC), Lesotho Manufacturers Association (LMA), and a new unit within the Ministry of Trade and Industry called the Business Advisory Promotion Services (BAPS).

Table 3 indicates the degree of monetisation of the economies of a number of SADCC countries. Lesotho's economy seems to be comparatively highly monetised.

In as far as development of financial markets is concerned, Botswana seems to be leading among BLS countries at present. It is followed by Swaziland. More banks in Botswana seems to signal keener competition and therefore relatively more developed and efficient market. Under Common Monetary Area arrangements there is an element of competition in Lesotho and Swaziland from South African banks and finance companies. Common Monetary Area allows free flow of funds among members. Bank of Botswana and the Central Bank of Swaziland issue certificates. This instrument is used for open market operations. The Central Bank of Lesotho markets treasury bills and bonds on behalf of government. Buyers are generally limited to banks, insurance corporations and a few parastatals as the denominations for treasury bills start with a minimum of one million Maloti. These securities are held until maturity. The trading of government securities is being developed at present.

In the non-banking sphere there is a stock-market in Botswana, albeit rudimentary. There is even a more rudimentary one in Swaziland. There is non at all in Lesotho. There is a unit trust in the making in Botswana (Sechaba Trust). There is none in Lesotho and possibly in Swaziland. There are efforts, however, to revitalise Lesotho Investment Holdings and to widen its scope so as to cover more companies. It will buy shares in a wider range of companies on behalf of its shareholders. Broader participation in the form of shareholding in Lesotho Investment Holdings is envisaged. Establishment of a brokerage house through which companies can float their shares is contemplated. Shareholding in that brokerage house will be open to all.

A wider range of services is best offered in the Botswana market (factoring, leasing etc.) followed by Swaziland. Lesotho has the narrowest range among the BLS at present.

4. CREATING A CONDUCIVE ENVIRONMENT FOR FINANCIAL MARKETS DEVELOPMENT:

In this section steps taken, in terms of fiscal monetary and other policies to pave way for the development of the financial markets are discussed.

Fiscal deficit has been reduced from the worst position of -20.3 percent of GDP and -10.3 of GNP in 1987/88 to about 1.2 percent of GDP and -0.7 of GNP in 1991/92. This has meant less borrowing by the government, especially from the banking system. The crowding out of the private sector borrowing has been reversed. In December 1988 58.0 percent of net domestic credit went to the government. The private sector had to settle for only 42 percent. In December 1991 the share of government in net domestic credit had dwindled to a mere 24.9 percent. The private sector got 75.1 percent. Private sector's share is expected to improve further.

External debt has been reduced from 38 percent of GNP in 1985 down to 34.5 percent in 1991. The bulk of the external debt, however, is concessional. Tight controls are placed on external commercial borrowing. Consequently the debt service ratio has never exceeded 4.7 percent.

Exchange rate regime is market related. It therefore gives no room for parallel foreign exchange markets.

Most of the parastatal organisations, especially those that require regular subventions or which run at a loss, will either be commercialised, privatised, trimmed down to manageable level or liquidated. This will further free government financial resources.

Interest rates are largely market related. If contemplated securities market is successful further liberalisation of interest rates can be anticipated. Domestic credit ceilings will, under such circumstances, also be reconsidered. That is because successful securities market will allow use of open market operations as a monetary policy instrument.

Tax exemption on yields from government securities has been lifted. These securities have remained attractive even without tax exemption.

Arrangements are already advanced regarding new mode of marketing government securities as mentioned earlier. (a) Securities will be sold by auction. They will be allocated according to the level of bids and amounts applied for. (b) They are going to be split into smaller denominations to enable members of the general public to afford them. This way even households can participate in the securities market. (c) Maturity dates will be staggered to ensure continuous operation of the market. (d) It will be possible to trade them in (i.e. discounting of securities). This enhances their liquidity. The intention is to use the Post Office network in order to reach all parts of the country.

This approach stands to benefit all parties involved. Ordinary members of the public will be eligible to participate in the securities market. Trading in securities, which enhances liquidity make the market more attractive. As this will provide an alternative to

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depositing money at the bank, banks may have to compete to lure depositors by offering higher rates on deposits. Auctioning will enable the government to raise a given amount of funds at a relatively cheaper cost. Banks may tend to lend more as one of the avenues of investing depositors funds, will have become an area of keen competition. With the adoption of more palatable indirect monetary instrument, such as open market operations, banks will be freed from tedious direct regulation such as domestic credit ceilings.

New foreign banks are permitted to enter the market provided that they are reputable. If they are newly-formed domestic banks, they should be prepared to adhere to prudential requirements and have sound management.

Bank supervision capability of the Central Bank of Lesotho has been enhanced. This service is being strengthened further.

Education of key officials in the public and private sectors and of community leaders, about financial markets is ongoing. It is meant to raise the level of knowledge and appreciation, thus paving way for cooperation and participation in the future.

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This preparatory work would be more complete if pertinent legislation could be reviewed and updated. More efficient administration of justice would also be essential. That would involve timeous handling of cases and execution of court rulings. Contracts have to be enforced, and disputes settled, timeously to avoid frustration of economic activity.

5. AGENDA FOR THE DEVELOPMENT OF FINANCIAL MARKETS:

Modest goals are preferable to grandiose schemes that cannot successfully be implemented.

What is needed is to continue and intensify preparatory work described in the preceding section.

There is need for establishment of new institutions to fill the gaps in the institutional infrastructure. With privatisation programme contemplated it would be opportune to kick off a stock market operations and a unit trust or stock brokerage firm to ensure broad participation in economic development. The idea of reviving the Lesotho Investment Holdings should be pursued vigorously.

Consideration should be given to introducing new instruments to strengthen the securities market and allow use of gentler indirect monetary policy measures and to ensure broader participation. For instance, the Central

Bank of Lesotho may consider issuing certificates to follow the example of the Bank of Botswana and the Central Bank of Swaziland.

Commercial canks in Lesotho are becoming more innovative. A number of new services may be introduced. A relatively wider range of products may be implemented.

Ways should be devised to harness funds currently outflowing in the form of premiums on insurance and assurance policies held with South African firms or in the form of provident and pension funds invested in South Africa. They are being used to develop the economy of South Africa and not that of Lesotho, at present.

For those members of the society who are not eligible for services of the formal sector institutions, development of legitimate informal and semi-formal institutions should be facilitated. It is through such institutions that some will flourish and graduate to become eligible for participation in the formal sector. In addition informal sector forms a significant portion of the economy in many African economies including that of Lesotho.

Experience has shown that developments based on culture and traditions stand a better chance of quick and resounding success than those which call for radical social cultural transformation.

6. REGIONAL DIMENSION:

Lesotho's financial markets, even in their current state, have been operating under common customs area and common monetary area arrangements. They are not protected from external influences and competition. Given ongoing socio-political transformation in South Africa, when the political stigma is fully removed both Southern African Customs Union (SACU) and the Common Monetary Area (CMA) may change in composition and character. Financial markets in Lesotho should be enabled to cope with the new arrangements.

SADCC is intent on formalising and intensifying economic integration among members. Financial markets are bound to feature as the programme of action becomes clearer. Such developments have to be accommodated in modernising and strengthening the financial markets.

PTA for Eastern and Southern Africa now has, as its ultimate goal, complete integration of economies of member countries. There is, inter alia, a phased monetary cooperation and harmonisation programme. The last phase is complete monetary union. That means there will be one currency and one central bank for the entire PTA. By then perhaps South Africa will have joined the PTA. There is already a PTA Development Bank in Bujumbura mandated to finance development within PTA. UAPTA (=SDR) travellers cheques have been in use for a few years. PTA Clearing House in Harare has been operating successfully for a few years.

It is important to take regional economic integration into account in developing financial markets.

7. CONCLUSION:

Between 1981 and 1988 there was a lull in the development of the formal financial markets in Lesotho. While in hibernation the markets were threatened by economic instability caused by resource imbalances and development of distortions in the economic system.

The structural adjustment programme which Lesotho is following has an element of initiating and nurturing the process of financial markets development in the country. This comes at the time when domestic economic needs and the international economic environment makes such a move a conditio sine quo non for continued growth and of keeping pace with the rest of the world.

An array of institutions and products is needed to fill existing gaps in the market.

Development of legitimate informal and semi-formal institutions needs to be facilitated in order to cater for the social groups that do not have ready access to the institutions in the formal sector.

Regional dimension has to be borne in mind in the development of financial markets. Changed Southern African Customs Union and perhaps Common Monetary Area, and intensification of economic integration under SADCC and PTA of Eastern and Southern Africa should be accommodated in the process. Markets being developed should be able to cope under such arrangements.

TABLE 1

FINANCIAL INSTITUTIONS IN BOTSWANA, LESOTHO AND SWAZILAND

(1990/91)

	Botswana	Lesotho	Swaziland
Commercial Banks	4	3	5
Development Bank or Equivalent	2	1	1
Building Societies or Equivalent	1	1	1
Other Financial and Related Institutions	3	-	-

TABLE 2

COMMERCIAL BANK DEPOSITS AND LENDING IN BLS COUNTRIES

	End December					
	1990	1989	1988	1987	1986	1985
BOTSWANA						
(P. mn)						
Total deposits		866.2	674.7	481.2	368	331
of which:						
Fixed deposits (6 - 12 months)		51.5	38.2	29.9	39.4	49.6
Savings		159.9	125.9	94.0	74.1	59.5
Bank Lending		529.7	368.9	285.3	273.4	257
Bank Liquidity (Excess)		162.7	166.5	90.2	22.6	61.0
LESOTHO						
(M. mn)						
Total deposits	542.9	502.3	448.1	353.9	319.5	280.8
of which:						
Fixed time deposits	45.3	38.9	39.3	37.5	24.8	23.7
Savings	230.7	202.8	166.0	134.0	111.2	92.1
Bank Lending	426.2	490.7	405.7	285.0	223.8	166.9
Bank Liquidity (Excess)	-	255.8	233.4	172.0	157.6	141.4
SWAZILAND						
(E. mn)						
Total deposits		632.7	439.1	341.6	303.4	241.2
of which:						
Fixed time deposits		382.3	254.8	188.6	166.4	144.6
Savings		67.7	73.0	58.0	50.1	40.0
Bank Lending		316.2	234.3	185.4	161.1	146.4
Bank Liquidity (Excess)		38.3	73.6	115.2	148.6	73.7

Sources: 1. Bank of Botswana, Annual Report 1989, Annual Report 1989
Bank of Botswana, Bulletin April - June 1990 Vol.8 NO.2.

2. Central Bank of Lesotho, Annual Report 1989, Central Bank of Lesotho Bank Supervision Reports

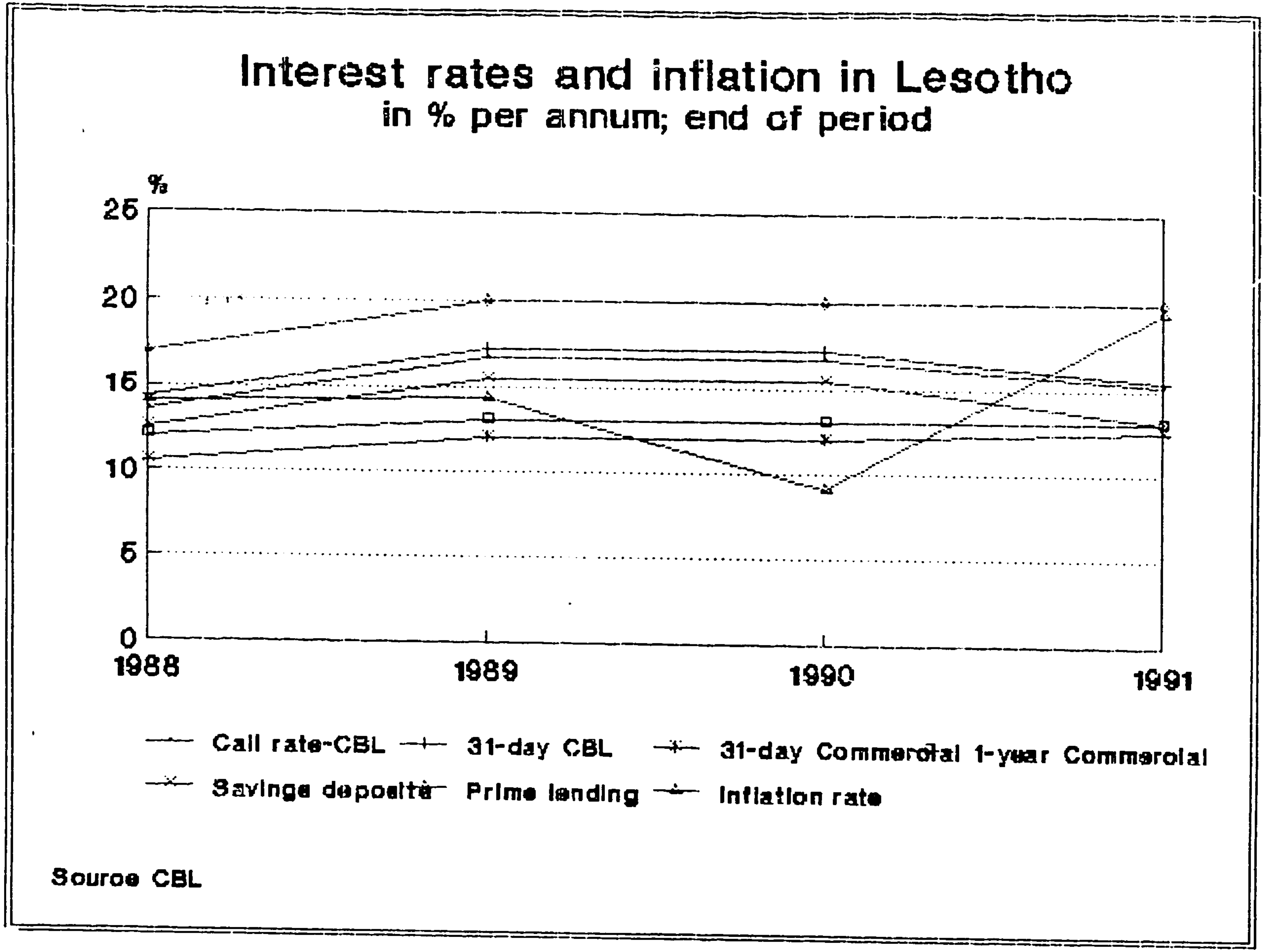
3. Central Bank of Swaziland, Annual Report 1988-89, Central Bank of Swaziland Quarterly Review June 1990.

TABLE 3

DEGREE OF MONETISATION IN SELECTED SOUTHERN AFRICAN COUNTRIES (1986-87)

	BROAD MONEY TO: GDP	GNP	NARROW MONEY TO: GDP	GNP
Lesotho	60.4	32.7	31.0	16.8
Botswana	29.4	31.7	10.1	11.8
South Africa	32.3	33.9	16.8	17.6
Swaziland	32.3	30.0	10.0	9.3

Source : - IMF, International Financial Statistics
- World Bank Tables
- CBL Quarterly Reviews


Interest rates and inflation in Lesotho
in % per annum; end of period
%
25
20
15
10
5
0
1988
1989
1990
1991
Call rate-CBL
31-day CBL
31-day Commercial
1-year Commercial
Savings deposits
Prime lending
Inflation rate
Source CBL

20. The CBL has realised that imposed minimum deposit rates or credit ceilings are only short-term substitutes for improved competition.

The need for more competition and financial instruments

It then seriously views competition as a necessary condition that will enable it to discharge its duties in a more efficient manner. The CBL has observed that problems that stifle competition in its financial system could emanate from lack of intitutions that provide project and venture capital as well as a range of financial instruments to stimulate and retain savings in Lesotho. To this end, it has within its structural adjustment programme, formulated a monetary policy that pivots on the development of financial markets in the country.

CBL taking the lead

21. Foreign and indigenous commercial banks have in Lesotho as elsewhere in Africa, not been able to orient themselves sufficiently to new circumstances and financial needs. They have, as a matter of fact, been guided by the principle of maximum return with minimum risk, i.e. avoiding rather than managing risk[6]. Notwithstanding its encouragement to commercial banks to direct more funds to the productive sectors, the CBL has taken upon itself to play a more direct role in this endeavour by establishing a Development Finance Division as well as streamlining new procedures for the broadening and deepening of financial instruments to the economy at large.

Export Finance Facility

22. In October 1988, the Export Finance Scheme was launched. The main objective of the Scheme is to provide back-up support for loan finance to encourage and enable commercial banks to extend credit to the private sector, especially export-oriented indigenous small-scale enterprises. Since the Scheme started credit operations, it has disbursed credits totalling M46.6 million.

The FSSP Project

23. As an endeavour towards supporting agricultural development in Lesotho, in 1990 the Central Bank assumed the role of an executing agency and depository of funds of the Food Self-Sufficiency Programme (FSSP). The FSSP is a revolving fund project founded by the Government of Lesotho to provide credit on favourable terms in order to promote self-sufficiency in food production in the country. The CBL uses the programme's fund to support lending institutions in their provision of agricultural loans.

Agro-Industries Facility

24. In addition to th[illegible]ove facilities, the CBL has also introduced the Industrial [illegible]nd Agro-Industries Facility which commenced its operations in September, 1991. The facility which forms part of the new industrial strategy embodied in the structural adjustment programme aims at:

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[6]) K.J. Moyana - Monetary Policy and Development Finance in Africa, in The Problems and Management of Development Finance in African Countries ACMS Dakar 1987 p.79

- the provision of medium and long-term finance for the development of the industrial and service sectors;

- the provision of working capital for medium and small scale business;

- financing for the restructuring of agro-industrial state-owned enterprises undergoing privatisation, and

- helping to finance privatisation by providing credits and venture capital to private small and medium sized companies.

Credit Schemes as catalysts of transformation

25. One word of caution is that the above credit schemes have not been established in order to distort the financial markets through official protection or any favours. On the contrary, they have been formed (i) to act as catalysts for the transformation of the rural sector and to create conditions for that sector to readily respond to impulses emanating from the modern sector. They have also been formed (ii) to transform commercial banks from the traditional practice of avoiding risk to that of managing it. The achievement of the above two aims could, to a large extent, enhance the effectiveness of monetary policy in Lesotho. It has been more than welcome to realise that one of the commercial banks, namely, Lesotho Bank, has taken the lead in the provision of credit to small-scale business through its Small-Scale Industries Project (SSIP). Besides the CBL, the latter is also receiving significant support from international multilateral institutions. It could only be hoped that Lesotho Bank's initiative will have a contagious effect to the rest of the banking system in Lesotho.

Financial instruments

26. One feature of the under-developed banking system in Lesotho is the lack of financial instruments. It is also one of the major constraints for an efficient operation of monetary policy. Consequently, the current monetary policy places a strong emphasis on the development of new financial instruments and the broadening or deepening of the old ones. Since 1979, only two financial instruments were used in Lesotho's financial markets, namely, treasury bonds and bills. These instruments were, however, used mainly for fiscal purposes i.e. to finance government deficit, rather than as monetary handles to control money supply. The main participants in the use of these instruments have been and continue to be the three main commercial banks. The household sector participation in the treasury bills market began only this year. Its participation in the bond market started a few years back but is still minimal.

Table 4

HOLDINGS OF TREASURY BILLS IN LESOTHO
(Maloti million)

	1989	1990	1991
Total Holding	154.1	154.1	154.1
Banking system	130.8	121.9	125.9
Central Bank	-	-	24.0
Comm. Banks	130.8	121.9	101.9
Non-Bank Sector	23.3	32.2	28.2
IBFI	23.3	32.2	28.2
Public	-	-	-

NBFI = Non-bank Financial Institutions
Source: CBL

Table 5

HOLDINGS OF TREASURY BONDS IN LESOTHO
(Maloti million)

	1989	1990	1991
Total Holding	73.9	25.2	21.8
Banking system	64.6	16.3	15.8
Central Bank	33.6	-	-
Comm. Banks	31.0	16.3	15.8
Non-Bank Sector	9.3	8.9	6.0
NBFI	6.8	6.4	3.6
Public	2.5	2.5	2.4

Source: CBL

Creation of secondary markets

27. In view of the limited number of financial instruments, their skewed and shallow penetration, the CBL is in the process of developing a market that will enable the household sector to play a more active role and hence, mobilise as much of the economy's resources as it is possible. This is hoped to be done through the creation of a secondary market and introduction of financial instruments which can be most suitable to local conditions. For a start, the CBL is now selling treasury bills at denominations that are low enough to enable the household sector to participate. In addition, treasury bill holders can now rediscount their treasury bills with the Central Bank any time they feel they need liquidity. This was not practised before mainly because of the excess liquidity of commercial banks which enabled them to hold their treasury bills up to maturity.

concluding remarks

28. The expansion of the financial markets and introduction of new financial instruments will go a long way towards improving the financial system in Lesotho:

i) it will afford savers and borrowers a choice to manage their assets and liabilities more efficiently in terms of liquidity, maturity and security;

ii) it will engender more competition among financial institutions and instruments and thus reduce administration, transactions and borrowing costs considerably;

and finally (iii) the economy will be more responsive to the impulses of the monetary policy.

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