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A Brief Look at an Important Book from World Bank, *Making Finance Work for Africa*

The need to reduce poverty in Africa is recognized as particularly compelling. So too, is the need for better access to finance for vast numbers of poor but entrepreneurially talented households and individuals so they can make the investments they need to make to increase their incomes and lift themselves out of poverty.

Thus, it is no surprise that the World Bank publication *Making Finance Work for Africa*, by Patrick Honohan and Thorsten Beck (H&B)-[1] stresses the need for to make finance work better to reduce poverty in Africa. Among the book's main themes are: a clear institution-building agenda for the financial sector, openness to regional or international solutions, and an inclusiveness approach. [2] The book can be accessed via the World Bank's website at

http://web.worldbank.org/external/default/main?theSitePK=258644&region=119222&pagePK=51083064&menuPK=258666&piPK=51246258.

The book's foreword rightly notes that it is "a wide-ranging study that defies brief summary," but this EG Technical Brief will boldly attempt the impossible.

Chapter 1, "Setting the Scene," begins with some good news: Reform – or at least the stirrings of it - has come to the financial sector in many African countries. Improvement in financial sector policies and institutions has been evident in: a lessening of financial sector repression, a move away from directed credit, considerable privatization of financial institutions, and partnerships between mainstream banks and microfinance institutions. Formal and semi-formal finance are beginning to advance. But there is still a long way to go. The book articulates the macroeconomic policy and other policy problems and failures underlying Africa's low level of financial sophistication, providing a good outline of how macro and other policies still need to be changed to increase the health, outreach and level of sophistication of the financial sector in Africa.

H&B characterize their approach to African finance as a blending in a complementary fashion of the two opposing perspectives of **"***modernism*" and **"***activism*.**"** which they see as ruling current thinking about financial systems development in Africa today. Such perspectives can be useful but can become blinders if one is not careful. According to H&B both perspectives accept the need for a sound enabling policy environment, one that includes macroeconomic stability and appropriate institutions–laws, rules, etc. as a point of departure. But the two perspectives diverge in important respects and here the need for a synthesis such as the one H&B provide becomes necessary.

Briefly, "modernism" seeks to put in place updated legislation and regulations that are friendly to creditors and to the initiation and expansion of large scale credit and finance operations by big banks and other financial intermediaries, enabling and empowering what H&B term the anonymous private financial sector to meet the economy's need for the financial intermediation services sector and encourage it to expand and scale up,

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in a cost-effective and responsive way. “Modernists”—and in this H &B concur with them—would have private sector large-scale financial institutions replace the remaining state-owned development financial institutions, with suitable incentives them to take on poverty reduction and be inclusive of the entrepreneurial poor and “base of the pyramid” elements of society in their banking and lending operations. Activists see a need to correct “market failures,” the very possibility, let alone the existence of which, hardly occurs to the “modernist” school practitioner. The need to correct these market failures in the activist’s view calls for special interventions by government. Activists as part of their agenda sometimes call for establishment of “special public, charitable or otherwise privileged financial intermediaries” to do what the anonymous private financial sector in its view cannot do to reach the “base of the pyramid” and be inclusive of the entrepreneurial poor. [3]

In Chapter 2 “African Financial Systems: Depth, Breadth, and Efficiency” “financial depth” is defined as the ratio to GDP of private credit (credit to the private sector) from the banking system A proxy for this is the ratio of bank deposits to GDP. The higher this ratio, the higher is the degree of financial intermediation, which promotes efficiency in the allocation of investment resources, and the greater is the depth, as H&B say, of the country’s financial system. Average annual growth of GDP per capita is significantly and positively related to a country’s financial depth, or to use the H&B terminology, to the depth of its financial system, after controlling for the impact of outside economic factors such as trade openness, government consumption, education, informal sector markets, inflation and base GDP. There are big deviations. Some countries are quite a bit off the line. Why? Efficiency (cost effectiveness) receives an extended discussion with which everyone concerned with financial systems should become familiar. It is defined as the “intermediation spread” (the difference between a bank’s average deposit rate and its average lending rate) with an alternative definition being the intermediation margin (see the book, p. 26, for what the authors mean by this). Both have to be assessed taking into account such factors as the profitability of the bank’s operation (a bank could have a very low spread but only because it was being forced or helped to operate at a loss or very low rate of return on its shareholders’ capital), the average risk of default on the loans it makes, and the extent to which it has monopoly power to increase its profits above the normal rate of return by setting its deposit and lending rates.

Chapter 2 explains why African countries generally score so low in the depth, breadth and efficiency of their financial systems. Low per capita incomes, unfriendly financial sector policies, such as high collateral requirements, regulatory uncertainty, and high taxation, contribute to the tendency of financial assets to be held offshore, to low extension of credit and low liquidity and to a large informal sector. Even though African banks are seen as profitable—or to the extent that they are—this is often largely due to a lack of competition and to high risk premiums. This chapter illustrates the broad range of factors that undercut financial viability. African capability in non-bank financial institutions, such as securities exchanges, insurance, pensions and collective savings, is currently low, in spite of the benefits such institutions can provide.

Chapter 3, “Finance for Long-Term Growth: Enriching the Flow of Finance to Transform the Economy,” provides a broader discussion of long-term growth issues and fund flows, classic regulatory issues and a description of the dilemma related to state-owned development finance institutions. It explores the role of government in long-term finance and the fundamental linkages between finance and law, enforcement, property rights and investor awareness. In doing so, it provides the rationale for judiciary development, fiscal policy, governance and credit provision as part of financial sector reform. Among other topics discussed are: traditional banking standards versus to Basel II standards for capitalization of banks; and foreign and domestic bank ownership.

H&B note the dismal record of state-owned development finance institutions (SODFIs) and find little reason to expect this to improve. They consider new kinds of DFIs. They argue that in the long-run privately owned non-bank financial institutions could play a greater role in adding social impact to profits for businesses than banks, although these may have a more limited willingness to take on financial risk. While acknowledging the difficulty of long-term private finance in Africa, H&B point to effective demand for investments in infrastructure, capital goods and housing finance requiring long-term capital financing.

The supply of funding for these activities, H&B maintain, should come from pension funds and institutional investors. Securities markets may be tapped, mortgage financing options explored. Discussing the relationship of public-private-partnerships to infrastructure programs, this chapter notes that the problems associated with a lack of a long-term yield curve, necessary for establishing a fair price for bonds and lack of investment banking skills for African markets argue for strong risk analysis talent in economic assessments for financial market activities.

Chapter 4, "Finance for All," provides innovative solutions for access to finance by African firms engaged in finance. "Base of the Pyramid" approaches to increasing farmer welfare through improved technology are reviewed: mobile phones, smart cards, satellite phones and portable computer technology. Specific case studies, such as Celpay in the Democratic Republic of Congo, Teba Bank of South Africa's smart card program, and Kenya's Equity Bank mobile banking unit provide notable best practice information in bottom-up approaches to innovation. This chapter supplements the earlier discussion in Chapter 3 on credit and outlines how credit to farmers and the agriculture sector can be provided through microfinance, providing it is recognized that due to the nature of agricultural production and unpredictable factors, they do not lend themselves to traditional microfinance methodologies. Honohan and Beck provide an insightful discussion of the unique attributes of African microfinance institutions, highlighting the concept of mutuality. This is defined as principles that support democracy, participation, solidarity, autonomy and liability. The concept of mutuality in African lending is important and addresses informality and small-scale intermediation issues. This chapter notes the lack of success of cooperative models, largely due to "malfeasance or insouciance."

Finally, Chapter 5, "Policy Choices in Current Conditions," captures the essence of the range of principled choices that must be made across the spectrum of "challenges and opportunities" that a country's decision-makers face in designing financial system development programs. The authors carefully consider a range of policy options and choices relating to credit market development, regulation, political circumstances (i.e., conflict states) and socio-economic factors such as the population base and natural resource endowments are considered. The concluding chapter provides logical stepping stone for elements of a comprehensive program for moving African finance forward to make it work better for both economic growth and equity: inclusiveness and competitive microfinance; regulation through strengthened registries, court procedures and credit flow enhancement; independent supervision accompanied by a free press and public awareness. The book concludes by addressing how certain financial market conditions are addressed at various stages of financial system development and in the circumstances of more and less advanced economies. It delivers a formidable argument for utilizing finance as a primary vehicle in finding solutions to African poverty.

This volume, in short, represents a splendid, engaging and highly readable contribution to the field of economics and finance in Africa. Patrick Honohan and Thorsten Beck have done a solid job of developing the case for improved microfinance practices, especially as related to the agriculture sector and the issues of credit provision. It gives a balanced and judicious presentation of the contending modernist and activist perspectives on financial sector development policy and the respective policy agendas of their adherents in government and civil society and arrives at a nice synthesis of the two agendas. *Making Finance Work for Africa* represents a policy-makers' approach to policy and analytical options for trustworthy and reputable financial market reforms and practices, and it is well worth reading and adding to your library to have an hand for consultation..

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[1] The Honoham and Beck (H&B) book is published by the World Bank. It contains a standard disclaimer at the beginning, however, on the part of the World Bank, however, to the effect that the findings, interpretations and conclusions expressed in it "do not necessarily reflect the views of the Executive Directors of the World Bank or the governments they represent. In addition to their own expertise, the authors have tapped a wide pool of expertise. In their acknowledgements section, H&B acknowledge the contributions of eleven individuals who provided draft materials on which they drew, comments from a five member external advisory group, advice from two peer reviewers, research assistance on quantitative issues by three researchers, and suggestions and comments from a number of named individuals, inside and outside the Bank, including Chris Barltrop, one of EGAT/EG's banking and financial markets specialists, and from a number of unnamed individuals. It has an excellent bibliography.

[2] As pointed out by Gobind T. Nankani, Regional Vice President for Africa of the World Bank, in his short but incisive foreward to the book.

[3] *H&B's critical appraisal of both modernism and activism* and their respective financial sector policy agendas, in chapter 1 of *Making Finance Work for Africa,* is an outstanding feature of the book. It effectively argues that African countries need to retain some sense of perspective in the extent to which they embrace one perspective or the other on financial system development. A good financial system development strategy should contain elements from both perspectives and both agendas.

Modernism seeks to put in place legislation and regulations and enforcement capability to foster development of modern large-scale financial institutions and networks by what the authors term the anonymous private financial sector on which modernists would have society place principal or even sole reliance to meet the economy's need for financial intermediation services. Though seeing the anonymous private financial sector as "atomistic" and non-ascriptive, (which may be true relative to government) modernists want to scale things up in finance even at low levels of economic development–to foster large scale finance, help the better banks grow big enough to reap economies of scale while still staying subject to competitive pressures to be efficient and serve customers well. (It may occur to at least some readers that a sector of a few large banks is not really "atomistic." But there is no magic number of enterprises in a sector below which competitive market becomes a monopolized or oligopolized one so long as there is reasonable freedom of entry into the sector when excessive levels of profits begin to be earned and serve to attract net entrants into the sector).

Modernists tend to overreach from time to time, H&B tell us, in implementing the modernist or modernizing agenda .Modernists are prone, say the authors, to "mindless transplantation of overambitious structures" and modernization for modernization's sake, oblivious of local context and regardless of whether it may be the best way of promoting economic growth. Modernists tend see any move, however overhasty or ill considered it may be, in the direction of transplanting what is currently considered to be best practice from advanced economies as unambiguously good. They try to do more than is feasible or desirable. If US banks are securitizing loans African banks should try doing it too. The modernist agenda includes rewriting ("updating") laws and accounting rules and procedures, and doing so in a way that encourages banks to scale up and adopt what currently passes for best practice in advanced countries. Going to extremes in modernizing a country's financial system and in trying to make it look just like what is cutting edge in the U.S., Great Britain or Switzerland will not necessarily pay economic growth dividends. Though financial system deepening is correlated with economic growth, modernization—a particular approach to deepening—is not synonymous with economic growth promotion.

Modernist thought in Africa considers that the government's involvement in maintaining macroeconomic stability and in institut-ing/mandating through writing laws and regulations and enforcing them, the generally accepted methods of best practice (account-ing, legal/regulatory, contracts and property rights) is essential to enabling strong, growth promoting market based financial sys-tems to develop.. To this it adds an emphasis on large scale finance, banking and credit. Laws should emphasize creditors' rights over debtors' rights, should promote transparency of the prospective borrower to the banks through credit bureaus, enforceability of contracts for creditors against debtors so as to reduce the risk and increase the profits from provision of credit and longer term fi-nance. It draws the line at integration of financial and industrial power. Industrial concerns should have to obtain their credit from independent privately owned banks, not banks in which they own controlling interests and can manipulate to their advantage.

Activism has another agenda, quite distinct from that of the modernist one. While not necessarily against the rewriting of rules and regulations by government agencies to promote modernization of and shift to larger scale operations by banks and other financial intermediaries, a*ctivism* says that government must take a broader view of the financial system and the clients it serves. Activists see a need to correct "market failures" the very possibility, let alone the existence of which, hardly occurs to the "modernist" school practitioner. The need to correct these market failures in the activist's view calls for special interventions by government. They sometimes call for establishment of "special public, charitable or otherwise privileged financial intermediaries" to do what the anonymous private financial sector in its view cannot do to reach the "base of the pyramid" and be inclusive of the entrepreneurial poor.

The consolidation of the Nigerian banking sector, which involved scaling up big time, is an example of the modernist approach (the authors consider the jury to still be out on its success). *Activism* relates more to grassroots finance, such as finance for micro-enterprises, agricultural finance (for small cultivators, not just big commercial farming operations) and agroenterprises –credit for ru-ral development and base of the pyramid segment's access to credit. The forum for what is today termed as social responsibility and entrepreneurship is placed in the *activist* program's implementation. Overall, the book views *modernism* and *activism* as complemen-tary, to be implemented in tandem for successful results.