PN-AAZ-299

isn = 54679

WHARTON ECONOMETRICS

Wharton Econometrics

150 Monument Road
Bala Cynwyd, PA 19004
215/667-6000

DEG

Development Economics Group of
Louis Berger International, Inc.

100 Halsted Street
East Orange, NJ 07019 USA
Tel: 201-678-1960 Telex: 138-152

THE ROLE OF THE AFRICAN FINANCIAL SECTOR IN DEVELOPMENT

JULY 31, 1987

Submitted to:

USAID/AFR/DP, Washington, D.C.
Under the Macroeconomic Services IQC

A Macroeconomic Services Partnership

TABLE OF CONTENTS

Executive Summary

Chapter 1: Background and Approach to Empirical Investigation

I. Introduction

A. Key Areas of Study
B. General Characteristics of Countries under Investigation
C. Implications of Country Characteristics for the Selection of Areas of Study

II. Survey of Literature

A. The McKinnon-Shaw School
B. Rural Credit Markets
C. Lack of Innovations in African Financial Markets
D. The Informal Sector and Informal Credit Markets
E. The Franc Zone
F. Implementing Financial Sector Reforms
G. Islamic Banking

III. Summary and Proposed Approach to Empirical Investigation

IV. Bibliography

Chapter 2: Country Studies

A. Guinea
B. Kenya
C. Malawi
D. Mali
E. Niger
F. Rwanda
G. Senegal
H. Somalia
I. Sudan
J. Zaire
K. Zambia

Chapter 3: The Potential for Financial Sector Reform

I. Conclusions
II. Data Availability
III. Criteria for Assessing Need and Prospects for Financial Sector Reform

A. Explanation of the Criteria
B. The Use of the Criteria
C. Suggested Approach
D. The Ranking Results
E. Guidelines for Allocating USAID Funds to Financial Sector Reform Projects

EXECUTIVE SUMMARY

Chapter I -- Background and Approach to Empirical Investigation

Our discussion of the role of the financial sector in economic development started with the repressed financial markets hypothesis propounded by McKinnon and Shaw, and the financial development models that have been derived from it. The McKinnon-Shaw argument is that distortions of financial prices (notably the interest rate and foreign-exchange rates) result in a repression of the financial system, and hence of the contribution it can make to the development process.

Our subsequent examination of other issues judged pertinent in a study of financial development in the context of the sub-Saharan African countries under investigation suggests that the McKinnon-Shaw position is too narrow, since it overlooks a broad range of macroeconomic factors that affect savings and investment behavior; is not well equipped to address the specific financing needs of the rural sector and its potential for savings mobilization; and fails to take into account the shortcomings of the formal financial sector in some countries, the need for financial sector innovations, and the importance of sequence in implementing financial sector reform.

In applying these premises to our empirical study of the 11 sub-Saharan African countries in our sample, account was taken of a number of limitations. At the same time, a basic framework of analysis for the countries to be examined was adopted that incorporated the salient points raised in recent studies of financial development.

Chapter II -- Country Studies

It is not possible to summarize in a relatively short Executive Summary the findings of each of these 11 country studies. Rather, the overall conclusions to the studies will be given below. Readers are referred to the full text and statistical annexes for more complete data.

Chapter III -- The Potential for Financial Sector Reform

CONCLUSIONS

In this section we examine the issues raised in Chapter 1 in light of the description and empirical evidence provided in Chapter 2. This enables us to determine the extent to which the theoretical premises presented in Chapter 1 are borne out in the cases of the countries in our sample, and also to decide what factors should be included in ranking countries according to the need and prospect for financial sector reform.

1. Macroeconomic Issues and Policy Considerations.

A. Chronic imbalances. Chronic fiscal and external imbalances were found to be at the root of the problems plaguing the financial sector in nearly all the sample countries.

B. Factors Complicating Savings Mobilization. These include low per capita income levels, lack of confidence in the formal financial sector, and the lack of depth in financial markets.

C. Receptivity of the Government to Macroeconomic and Financial Sector Reform. Government attitudes toward reform programs advocated by the donor community vary considerably. In all sample countries, major structural adjustments have only just begun.

2. Financial Sector Regulations.

A. Interest rate ceilings. There is evidence that interest rate ceilings in many of the countries we examined have have stymied financial intermediation, encouraged consumption at the expense of investment, and introduced a number of other distortions.

B. Selective credit controls. Selective credit controls in the form of sectoral lending quotas or prior authorization requirements have been justified as a means of insuring that "priority" sectors have access to bank credit. In most instances, however, selective credit controls have failed to fulfil their promise and instead hampered the process of financial intermediation.

C. Credit ceilings applied to individual banks. In nearly all of the sample coutries, monetary and credit policy include a global restriction on the growth of domestic credit. However, in a number of countries, the government has distributed available credit to individual banks according to a variety of formulae, usually with detrimental effects to the financial sector.

D. Excessive reserve and/or liquidity requirements. In a few of the countries in our sample, high reserve requirements, coupled with other restrictions (credit ceilings, funding requirements, etc.) have discouraged the growth of financial intermediation.

E. Quality of Central Bank control. The quality of Central Bank control varies among the countries in our sample, but on the whole it is weak and has not been adequate to detect or prevent financial deterioration and instability in financial institutions.

3

3. Structure of Financial Sector and Performance of Financial Sector Institutions

A. Public Sector Domination of the Banking Sector. The countries in our sample are characterized by varying degrees of state-ownership or government control of the financial sector. In many cases, government domination has had adverse effects on the performance of the financial sector and on the health of the economy as a whole.

B. Specialization in Financial Institutions. In many of our sample countries, governments have created specialized financial institutions in response to perceived market imperfections. In general, the preformance of the highly specialized institutions has been poor, both because of inherent weaknesses in the institutional framework and because of the undiversified and high risk nature of its portfolio.

C. Sectoral Imbalance. Sectoral imbalance is a very common phenomenon in the countries we examined, and the financial sector is often an instrument in perpetuating or even aggravating it. A skewed distribution of credit in favor of the tertiary sector is almost always partly to blame.

D. Bias in Favor of Short-Term Lending. In most countries considered in this study, there is a strong bias in favor of short-term lending. This constitutes a bias against productive sectors, which have long start-up phases, require long-term financing commitments, and generate profits only in the medium term.

E. Lack of Innovations. The incidence of innovations adopted by the formal financial sector in the countries in our sample is low. This is mostly due to tight regulation, lack of competition among financial institutions, and the large element of risk in innovations.

F. Informal Credit Markets. The status of information about informal credit arrangements in the countries we studied varies considerably. On the whole, however, there is limited information about this important sector.

G. Semi-formal Credit Institutions. Semi-formal credit institutions have become an important factor in the financial systems of a number of countries considered here. The experience to date with these types of measures is not uniform.

H. Islamic Banking. The record of Islamic banking to date in the countries in our sample is rather uncertain. On the whole, it must be concluded that Islamic banks have shown little evidence of acting very differently from traditional banks.

THE RANKING RESULTS.

DATA AVAILABILITY

Countries were ranked according to the availability of the following data:

1. Data on the structure of deposit and lending interest rates.
2. Information on non interest and transaction costs (e.g. fees, compensatory balances, and high transportation costs).
3. Data on structure of banking sector liabilities and assets.
4. Data on the sectoral allocation of credit.
5. Data on the use of central bank rediscounting facilities.
6. Information on the quality of bank loan portfolios.
7. Data on individual banking institutions.
8. Data on non bank financial institutions.
9. Data on the semi formal (e.g. cooperatives and credit unions) and the informal financial sectors.
10. Detailed information on financial sector regulations.
11. Information on central bank monitoring and inspection.
12. Information on equity financing institutions.

B. Country Ranking by Data Availability

1. Mali
2. Kenya
   Rwanda
3. Niger
4. Zaire
5. Malawi
   Senegal
6. Somalia
7. Sudan
8. Guinea
9. Zambia

THE NEED AND PROSPECTS FOR FINANCIAL SECTOR REFORM

The following criteria were used for evaluating the need and prospects for financial sector reform:

A. Criteria relating to the macroeconomic environment:

1. Inflation, based on the GDP deflator.
2. Government budget deficit, as % of GDP.
3. Current account deficit, as % of GDP.
4. Debt-service ratio.
5. Annual real per capita growth.
6. Recent progress toward current account liberalization (e.g. the trade regime).
7. Recent progress toward capital account liberalization (e.g. exchange controls on capital flows).

B. Criteria relating to the financial sector:

1. Extent of public sector ownership of the financial sector.
2. The public sector share of total domestic credit.
3. Real deposit rates.
4. Real loan rates.
5. Individual bank credit ceilings.
6. Sectoral credit controls.
7. Percentage of non performing loans as an indicator of financial sector stability and performance.
8. Urban concentration is an indicator of the outreach of the financial sector to agricultural and rural markets.
9. Quality of commercial bank managment. A qualitative criterion.
10. Ability of the central bank to monitor commercial bank safety and soundness.
11. Degree of government progress on previous financial sector reform, as evidenced by related actions and policies.

The following ranking schemes were accordingly derived:

Macroeconomic Environment, Ranking by Perceived Stability and Auspiciousness for Financial Sector Reform.

1. Rwanda
2. Kenya
3. Malawi
4. Niger
5. Mali
   Somalia
   Senegal
6. Sudan
   Zaire
7. Zambia

* Guinea

Ranking by Perceived Strength of the Financial Sector

1. Rwanda
2. Zaire
3. Kenya
   Malawi
   Mali
   Niger
4. Senegal
5. Sudan
6. Somalia

* Guinea
* Zambia

6

Note: Data on Guinea and Zambia are so sparse that there are serious gaps in filling in the criteria data. As such we felt it would be safer to exclude Guinea from the macroeconomic ranking and both countries from the financial sector ranking.

GUIDELINES FOR ALLOCATING FUNDS TO FINANCIAL SECTOR REFORM PROJECTS

We suggest a three-pronged approach to financial sector reform. The primary reform process, which is needed in all countries but most imperatively in the countries with the weakest financial sectors, should focus on basic reforms aimed at strengthening existing and reforming existing financial institutions. The fact that many of the countries most in need of these reforms are often in highly unstable state as far as their macroeconomic environment is concerned does not preclude the possibility of basic reforms, which need not be blocked by instability of the macroeconomic environment. Indeed, these reforms are often conducive to an improvement in the macroeconomic environment, and go hand in hand with structural adjustment efforts.

Liberalizing reforms should ideally be reserved for countries with both a relatively stable macroeconomic environment and, in some but not all cases, a strengthened financial sector. Prior liberalization of the current account is of the essence, to avoid having the financial sector adjust to price signals which are out of tune with interntional prices.

Reforms aimed at revitalizing the financial sector by increasing competition are also imperative in many countries, and can be contemplated fairly early for countries whose particular conditions make them candidates for this type of reform. Although they often are ambitious, such reforms can be contemplated at various stages of financial development.

The three-pronged approach to financial development is not meant to be an inflexible categorization of USAID projects. Reform by formula, always problematic, is singularly inappropriate in the case of financial sector reform. Extreme caution should be exercised in pushing for financial sector liberalization before the macroeconomic environment is ready for it, however; the potential for counterproductive results is too great.

GENERAL COMMENTS

1. The ranking scheme developed here is, like all ranking schemes that seek to draw qualitative conclusions from quantitative indices, highly arbitrary. It is discussed at length in our third chapter, primarily because the scope of work

specifically called for it, but we feel that its usefulness is limited. More useful would be an examination of the component indices that were used for setting up the ranking scheme, as these may shed some light about comparative conditions in the countries under consideration.

2. Although the scope of work called for a discussion of USAID projects in the sample countries in a separate chapter, we found that existing material on USAID projects was uneven, which would have led us to conclusions about USAID activities that are incomplete and unreliable. Instead, we preferred to include a discussion of what material was available in the chapters on each country. In some cases the discussion is kept very brief, generally a reflection of the paucity of information on USAID activity in the country in question.

3. We feel that the recommendations for further studies are perhaps the most valuable part of this paper. These recommendations are listed separately for each country. In some countries (e.g. Zambia) the serious shortage of information makes it difficult to determine into what studies funds should be channeled. The missions operating there may have a better insight into the feasibility of meaningful field studies.

8

CHAPTER 1: BACKGROUND AND APPROACH TO EMPIRICAL INVESTIGATION

I. INTRODUCTION

A. Key Areas of Study

This chapter will focus on a discussion of the key issues pertaining to the role of the financial sector in the development process. The traditional theory in this field, which is primarily the Mckinnon-Shaw repressed markets hypothesis, will be reviewed and analyzed, as will critiques of its applicability. We shall then discuss other topics judged to be of relevance to financial development and the general issue of financial sector reform, and, where applicable, survey the literature on these topics. The chapter will thus include a discussion of:

(1) the basic tenets of the MacKinnon-Shaw approach to financial development, namely a general discussion of the repressed markets hypothesis, its extensions and its limitations.

(2) specific institutions such as rural financial markets and agricultural credits, informal credit markets, and semi formal credit institutions (cooperatives and credit unions);

(3) policy issues like currency zones (primarily the West African Monetary Union) and the proper sequencing of financial sector reform;

(4) institutional issues such as the scope for financial sector innovations and the relatively new field of Islamic banking.

B. General Characteristics of Countries under Investigation

The selection of these areas of study stemmed from our assessment of the applicability of the literature to the subject of the role of financial sector to development, particularly in the case of the sub-Saharan African countries under investigation. A preliminary examination of overall conditions in these countries suggests that they possess characteristics which complicate the role played by the financial sector, namely:

- The financial environment in all of these countries is moderately to highly unstable. In many instances inflation is in excess of 30 %, and even in the countries where it is lower than that, it is typically at a double-digit level on average. More alarmingly, it does not appear that any of the countries under investigation has reached the stage of what can be termed "stabilization", in the sense that inflationary pressures are tapering off and a return to relative price stability is in sight. Rather, the inflation rate has fluctuated considerably in recent years in most of the countries considered in this study, so that it is highly unpredictable.

9

- Fiscal and external imbalances are usually serious. Fiscal imbalances (in the form of gaping, and often widening, budget deficits) often result in heavy borrowing by the government or the parastatal sector from commercial banks, reducing the funds available for the needs of other sectors and contributing to inflationary pressures. External imbalances (in the form of large current account deficits, often made worse by capital flight) result in pressure on the currency (and hence often in overvaluation and the development of a black market) and give rise to barriers to trade and various curbs and controls. Both types of imbalance often contribute to the growth of external debt, which has saddled most of the countries in our sample with a heavy debt burden that has drained their resources.

- The financial sector in most of these countries either is or has until recently been subject to repressive regulation. The most crippling of these is interest rate ceilings, which often yield low or negative interest rates on both deposits and loans. Other restrictions include overall credit ceilings (usually applied uniformly to all banks), selective credit controls (which is often combined with credit subsidization to certain sectors), and restrictions on entry (which often fosters the dominance of a large, state-owned bank specializing in financing the government and the parastatal sector).

- A number of other controls exist in other sectors in nearly all the countries under consideration. Foremost among these is price controls, which have often had a detrimental affect on production and exports, as well as exchange rate controls, import quota and tariffs, and restrictions on capital transfers. To the extent that these constraints must be removed to permit a normal functioning of the economy, they create problems for financial sector reform, inasmuch as the timing of such reform vis-a-vis other necessary reforms becomes problematic.

- The level of monetization of the economies studied here is typically low compared not only to more developed countries but also to other sub-Saharan African countries. In addition, the ratio of demand deposits to money in circulation is also low, as is the proportion of financial assets in total wealth. This stems largely from the low level of confidence in the financial system, itself the result of high, unpredictable inflation and an inadequate level of services.

- Per capita income levels are extremely low compared to other developing countries. This complicates the task of mobilizing savings; in many instances the average savings rate is negative and is almost certain to remain so for some time, suggesting a need for continued aid flows until domestic financial resources can be mobilized.

10

- Sectoral imbalances are typical problems with different manifestations in the countries under investigation. These imbalances are almost invariably accentuated by distortions in the financial sector, which arise in one or more of the following forms:

    - The primary sector (typically agriculture or mining) which usually accounts for a high proportion of both GDP and domestic employment, faces chronic problems which are exacerbated by the difficulty of obtaining financing, a factor which fosters dependence on foreign aid and/or financing and complicates the task of maintaining productivity in the sector.

    - The secondary sector (usually industry) likewise faces numerous obstacles, not the least of which is the lack of adequate financing.

    - The tertiary sector (usually services and commerce) is usually growing rapidly, often at the expense of the primary sector, and is usually far better able to obtain financing than the primary or secondary sectors. The problem this poses stems from the fact that growth in this sector generally contributes little to productivity or employment, and often skews income distribution further in favor of the wealthy and of the urban population.

The fact is that the financial sector in most cases is a major culprit in promoting these sectoral imbalances. The reasons for that are not always obvious or the same; they usually include the following:

    - Information costs are lowest in the tertiary sector;

    - The financing needs of the commerce sector are typically short-term in nature, which is frequently not the case with the financing needs of the primary and secondary sectors;

    - Biases may be built in because of political or family connections between managers of financial institutions on the one hand, and private entrepreneurs (who usually operate on a large scale) in the service sector, or the government and parastatal bureaucracies on the other.

- The supervision and control to which the financial sector is subject are often of low quality, being constrained by:

- Inadequate skills of monetary authorities
- Low standards of accounting
- A less than satisfactory legal system, and the lack of clarity in laws pertinent to financial intermediation, notably those governing property rights and contracts
- Lack of independence from the government of the Central Bank
- A credit control policy constrained by the need to conform to the requirements of a restrictive exchange rate regime, an extreme case being membership in a currency zone.

C. Implications of Country Characteristics for the Selection of Areas of Study

In selecting the major areas that would form the focus of this study, it was necessary to incorporate the above-mentioned characteristics in the formulation of the theoretical foundation of our investigations. The starting point of any consideration of the role of the financial sector in any context revolves around the following generic functions assigned to the financial sector:

- **Savings mobilization:** drawing funds from surplus units by offering them an incentive to favor future over present consumption (by offering them a high real return on their savings), and offering them financial assets that correspond to their needs and preferences

- **Maturity structure transformation:** providing liquidity to asset-holders while at the same time extending credit of a longer maturity to users of funds

- **Allocating funds to efficient users:** channeling funds to projects that yield the highest expected present value, duly adjusted for risk

- **Pooling risks and providing economies of scale:** assuming risks that would be overwhelming to the typical individual asset-holder by holding a diversified portfolio of assets that eliminates systematic risk, and offering the advantage of lowered per unit costs to both depositors and borrowers that stems from the large scale of operation available to financial intermediaries

- **Provision of services:** providing services to both depositors and borrowers, including foreign currency transactions, letters of credit, information and counseling, correspondent banking, etc.

In the case of the countries we are examining, the following caveats must be borne in mind:

- Savings mobilization involves more than issuing an array of financial instruments yielding a high positive return; it typically involves giving potential savers reason to feel more confident about holding financial assets, which will often entail initiating innovations that make financial intermediation more amenable to the environment in which it operates. Hence the need to address the issue of innovations, and examine semiformal financial institutions (cooperatives and credit unions) and novel institutions like Islamic banks.

- If the financing needs of small-scale farmers, urban entrepreneurs and businesses at an early stage of their development are to be met at all, the strong bias in favor of short-term lending will have to be counteracted, and the circumstances that have given rise to informal credit markets must be studied to insure that competition from the formal financial sector does indeed prove beneficial to the informal sector. This is important since the formal sector is in the position of using economies of scale and risk pooling to reduce the cost of credit to these sectors. This suggests the need to study rural financial markets and informal credit markets and their relationship to the rest of the economy.

- The allocation of funds to efficient uses requires the removal of macroeconomic distortions, and also of discriminatory implicit or explicit financial sector regulations. This necessitates consideration of the macroeconomic environment and any rigidities it may contain, linkages between economic sectors, and the response of savings to macroeconomic as opposed to financial stimuli.

- The management of the financial sector requires an understanding of the role of a central bank in a system that precludes open market operations. It also requires an understanding of the constraints that membership in a currency zone imposes on the conduct of monetary policy in certain countries.

- In defining the process of reform in the financial sector, allowance must be made that such reform is often untenable unless the problems besetting the economy as a whole are addressed through a process of stabilization and structural adjustment. Appreciating the need for appropriate sequencing of financial sectoral reform in such a process is of the essence.

13

II. SURVEY OF LITERATURE

To gain a better understanding of the problems experienced in the financial sectors of the countries in our sample, we propose to follow the literature in the following key areas:

1. The McKinnon-Shaw repressed financial market school, its extensions and limitations.
2. Rural credit markets, their specific problems, needs and ways of developing them.
3. The nature of and scope for financial sector innovations.
4. Informal credit markets, their main characteristics, the role they play and the problems they present.
5. The franc zone currency union, and what it means for monetary policy and credit control in the member countries.
6. The issue of sequencing in implementing financial sector reform.
7. Islamic banking, its main characteristics and an assessment of its performance to date.

In each case, the discussion will focus on a presentation of the major issues and of the overall thrust of the literature. In some cases seminal articles will be analyzed critically. In all cases, an annotated bibliography will be included that will summarize the contents of the major articles on the subject. Supplementary unannotated bibliography of less important or less pertinent articles (or articles whose main thrust is evident from the title) will also be included.

In the particular case of the MacKinnon-Shaw hypothesis, the discussion of key articles will be presented in the main body of the chapter. An unannotated bibliography on the McKinnon-Shaw school, its various refinements and critiques will be appended to the chapter.

A. THE MCKINNON-SHAW SCHOOL

The starting point of the literature geared specifically to the subject of the role of the financial sector in the growth process is the position advocated independently by McKinnon (1973) and Shaw (1973) that criticizes low controlled interest rates and financial repression. Both were basically reacting to the Keynesian and neo-structural positions that saw a low interest rate policy as prescription for growth, given its supposedly stimulatory impact on investment. McKinnon and Shaw both challenged this assumption by placing the investment decision in financial perspective.

McKinnon's and Shaw's starting positions are not identical, nor are the theoretical assumptions underlying their analysis. McKinnon bases his analysis on outside money model, which effectively implies:

- Financing is limited to self finance
- Investment expenditures are lumpier than consumption expenditures, so that investment cannot be undertaken unless money balances have first been accumulated.

This is equivalent to the hypothesis that demand for money is positively related to the proportion of investment in total expenditures - the outside money (commodity money) assumption held by Tobin in contradistinction to the Keynesians. This is "the complementarity hypothesis", which implies that there is a complementarity between money and physical capital. This complementarity provides the link between savings and investment in McKinnon's model, suggesting that money supply conditions have a first-order impact on savings and investment decisions. (McKinnon, 1973).

Shaw's position stresses the role of the financial intermediation process. The chain of causality in Shaw begins with higher real institutional interest rate leading to increased financial intermediation between savers and investors, which in turn raises real returns to savers and lowers real costs to investors. This is achieved through the traditional advantages provided by financial intermediation, namely maturity preference transformation, risk pooling, economies of scale, lower information costs to both savers and investors, and increased operational efficiency. This is a restatement of the debt-intermediation view which Shaw himself first advanced with Gurley (Gurley and Shaw, 1960). It precludes all notion of "outside money" (money not backed by private debt) or complementarity of money and investment, postulating instead an "inside money" assumption, or money backed by private debt - for the most part productive investment loans. This emphasis on financial intermediation necessitates an increase in real returns on all forms of wealth, money included, in order to boost savings. (Shaw, 1973).

The positions of both McKinnon and Shaw agree in one particular, namely that low interest rates have a detrimental impact - according to McKinnon because they depress savings and investments, and according to Shaw because they discourage financial intermediation. Under both assumptions repressed financial markets will lead to lower growth and a suboptimal allocation of resources. The two views can, on the other hand, be viewed as complementary (as they have been by Molho, 1986), to the extent that McKinnon's argument applies to projects financed internally, while Shaw's applies to projects financed through borrowings, and most projects tend to be financed in both ways simultaneously.

The normative implications of the McKinnon-Shaw position were elaborated in extensions of their work by the authors themselves and by others who adopted their approach. Among the arguments cited by the McKinnon-Shaw against financial repression and in favor of liberalizing financial intermediation are the following:

- If a ceiling is placed on nominal deposit rates, inflation will draw savings toward nondepreciating assets of which there is a fixed supply, a process which cannot be equated to a growth in investment. As this bids up the price of the nondepreciating assets, the only impact will be an increase in the wealth but not in the income of the household sector, which, in an intertemporal utility maximization setting, will lead a lower average propensity to save. (See Fry and Williams, 1984).
- If a ceiling is placed on nominal loan rates, loanable funds will be rationed according to criteria other than those indicated by the cost of credit. Consideration like the nature and quality of the collateral of the borrower, his standing or influence, political pressures, the size of the loan, or outright bribery will be the main determinants of loanable fund allocation. (Cho, 1984).
- Since restricted loan rates preclude the charging of high risk premia, risk taking on the part of financial institutions will be discouraged. This will result in discrimination against high-yielding investment opportunities, and favor investments that yield returns barely above the ceiling loan rate. (Fry, 1982).
- Financial repression tends to give rise to dualism developing economies. To the extent that entrepreneurs are restricted to self-financing, they will tend to limit themselves to investment in traditional technologies, which have low productivities. If the investor is, however, able to borrow at an administratively fixed interest rate, he will prefer to invest in new technologies with high productivities. This will result in a situation where two different production techniques coexist in a developing economy, implying suboptimal investment efficiency. (McKinnon, 1973).
- Given that dualism is promoted by financial repression, and that borrowing at administratively fixed interest rates is available to some investors (usually wealthier, more powerful investors with larger borrowing needs) but not to others, financial repression can result in greater income inequality. This is especially true as dualism will yield inefficient small-scale investment in some cases and excessively capital-intensive (because capital is underpriced) investment in others, resulting in reduced demand for labor and lower wages. (Krugman, 1978, and Cho, 1984).

The policy implications of the McKinnon-Shaw camp are thus generally as follows:

- Repressive regulation of the financial sector is unambiguously harmful in developing countries as it discourages both savings and investment, fosters an inefficient allocation of resources, encourages the coexistence of two levels of technology, and worsens income distribution.
- Financial liberalization (the removal or at least gradual

16

phasing out of repressive regulation) is a high priority, as it would alleviate the harmful effects of repressive regulation and set the country on a financial development course that would lead to higher savings, a better allocation of resources, balanced growth, and an improved income distribution.

A significant part of the literature on financial development produced since 1973 has used the McKinnon-Shaw hypothesis as its starting point. Works by the McKinnon-Shaw school can be sub divided into the following groups:

- Formal steady-state financial development models, including:

    - o A model utilizing a constant capital-output production function and assuming unused fixed capital in the economy, developed by Kapur in 1976.
    - o A model utilizing Kapur's production function but assuming full capital utilization and a fixed proportion of capital financed by bank borrowing, developed by Mathieson in 1980.
    - o A two-sector model examining the impact of financial repression on the average efficiency of investment, dispensing with the Kapur-Mathieson assumption of constant efficiency of investment, developed by Galbis in 1977.
    - o A model of financial development presented by Fry in a series a papers (1977 to 1986), designed "explicitly for empirical testing", and introducing real institutional interest rates in five different places.

  All of the steady-state financial development models suggest a growth-maximizing deposit rate equal to the competitive free-market equilibrium rate. That competitive rate can be boosted by lowering the inflation rate and boosted by lowering the inflation rate and paying the competitive loan rate on required reserves, resulting in an increased real supply of credit without affecting the loan rate. These models thus favor a policy of abolishing interest rate ceilings, eliminating reserve requirement taxes, and guaranteeing free entry into the financial system -that is to say, financial liberalization.

- Formal financial development models incorporating dynamic adjustment, including:

    - o Kapur's model positing adaptive inflationary expectations and money market disequilibrium, developed in 1976.
    - o Mathieson's model positing adaptive inflationary expectations and a decaying stock of fixed-interest bank loans, developed in 1980.
    - o Fry's model positing the same dynamic adjustment mechanisms as Kapur, except that adaptive expectations

17

are extended to a broad range of economic variables and supplemented with an expectations augmented Phillips curve, developed in 1977.

All three models yield the result that boosting the nominal interest rate will increase income and reduce inflation at the same time.

- Financial development models incorporating the assumption of an open economy, including:

  - o Kapur's model making the real return on working capital a negative function of the real exchange rate, developed in 1983.
  - o Mathieson's model assuming investment and growth to be positively affected by an appreciation in the real exchange rate, as the latter brings about a higher real loan and deposit rate during transition, developed in 1979.

  Kapur concludes that devaluation to the full extent dictated by the trade balance may prove suboptimal, while Mathieson's model finds overdepreciation to be optimal.

The McKinnon-Shaw school's main contribution lies in highlighting the role of financial intermediation in the growth process, and pointing to the harm done by repressing financial markets. However, there are a number of problems involved in applying the McKinnon-Shaw approach to the financial sectors of the 11 countries in our sample. Some of these stem from the applicability of their hypothesis to the countries in question, others from general theoretical limitations of the McKinnon-Shaw approach. In particular, we need to investigate the following:

- To what extent are financial markets really repressed in the countries studied here?
- In cases where repressive regulation has been diluted or phased out, have any of the benefits anticipated by the McKinnon-Shaw school materialized?
- What does the existence of a large, thriving informal credit market in some (if not all) of the countries in our sample imply for argument for liberalizing the formal financial sector?
- To what extent does the existence of macroeconomic distortions and linkages that foster rigidities weaken the link between savings and interest rates, limiting the gain in savings that can be achieved by allowing interest rates to rise?
- Are the needs of the rural sector, which dominates the economy in the countries in our sample, as well as its potential for savings mobilization best fulfilled by liberalizing the formal financial sector? This issue is raised in the literature and field studies dealing with rural credit and cooperatives.

- Is there room for institutional adjustments, notably for innovative contractual arrangements, to expand the role of the financial sector in a manner that goes beyond the strict regulatory framework posited by the McKinnon-Shaw school? This question is raised in the literature on financial sector innovations.
- Can financial sector liberalization be implemented in countries which are in need of far-reaching reforms in the rest of the economy in order to enter into the stabilization stage? This point is discussed in the literature on reform sequencing.

It is therefore essential to evaluate the McKinnon-Shaw approach in two contexts:

(1) A theoretical evaluation, drawing on the recent thinking on the subject of financial development. This will be done in the remainder of Chapter 1.
(2) An empirical evaluation, examining the pertinent questions in the case of each of the 11 countries under investigation. This will be done in Chapter 2.

From that we propose to derive a new framework of analysis that will make possible the determination of an optimal ranking for the allocation of USAID assistance funds targeted for the promotion of financial reform in the 11 countries examined in this study.

B. RURAL CREDIT MARKETS

A discussion of rural credit markets is a logical starting point of any application of financial development theory to sub-Saharan Africa. This is because:

- The rural sector is often the focus of efforts aimed at boosting employment or promoting exports in sub-Saharan African countries.
- The credit needs of the rural sector are generally difficult to satisfy in most sub-Saharan African countries, which are in the early stages of financial development, as the sector's information costs are typically high, and financing innovative technology in the sector requires long-term commitments of funds.
- Given the large proportion of the population in rural areas, savings mobilization must take account of the untapped potential for mobilizing rural savings.

The literature dealing with the subject can generally be divided into two schools of thought. The first, namely the Ohio State approach pioneered by Adams, von Pischke and others, emphasizes the potential for savings mobilization in rural areas, and urges the development of financial institutions capable of tapping rural savings while at the same time meeting the credit needs of agricultural producers. The second school of thought,

19

which is more recent, was pioneered by Binswanger and is gaining in currency; it attempts to account for the inadequacy of financial institutions in rural areas and the reasons why it may be too premature to seek to develop them in certain areas.

The Ohio State approach focuses on semiformal financial institutions such as credit unions, village associations, etc. which have a natural advantage in tapping rural savings and extending credit in rural areas. The empirical work performed by Adams and others began by emphasizing the immense potential for rural savings, as evidenced by the high saving propensity among farmers in Japan, Korea, and other countries. Next the proponents of the Ohio State approach sought to explain why semiformal financial institutions have been fairly successful in carrying out their intermediating function in some countries like India, but significantly less so in other countries, the sub-Saharan African countries being a good example. They cite as constraints on financial development factors such as high information costs, limited access to transportation networks, and, above all, excessively low interest rates. That subsidized credit is the ruin of agricultural financing is a key tenet in the thinking of the Ohio State school of thought.

There are a number of problems with the Ohio State approach. In particular:

- The overall notion of financial development in Ohio State studies is largely modeled after financial systems in more developed countries.
- The Ohio state approach takes little account of the sociological - and even anthropological - factors that practically preclude the development of certain financial institutions in some areas.
- The Ohio State approach is sometimes guilty of overlooking the need for addressing some very basic problems relating to the mode of production and social relations <u>before</u> contemplating serious financial development.

Binswanger's alternative approach to the problem of financial development dwells on these issues and attempts to evaluate existing financial arrangements in the broader context of agricultural systems. Among the major contributions of the Binswanger approach are:

- The highlighting of land tenure systems as a major factor in determining credit allocation.
- The distinction between land-scarcity and land-abundance as a determinant of the applicability of collateral in credit agreements.
- The renewed emphasis on the need to address the basic issues of labor productivity and production relations in agriculture before seeking to bring about financial innovations that may be premature.

20

The distinction between land-scarcity and land-abundance is of the essence in dealing with sub-Saharan African countries, where land-abundance is often a fact of life. In such countries, Binswanger finds, the potential for meaningful financial development through institution-building is seriously hampered by the impossibility of devising collateral schemes. Where land cannot be used as collateral, the alternatives are scarcely encouraging: cattle pose a problem of moral hazard, and the pledging of labor is likewise problematic, especially as far as enforceability is concerned. In such cases the major prerequisite for any kind of development, financial or otherwise, is the development of markets for agricultural produce that may initiate the process of commercialization of land, eventually giving rise to a land tenure system more amenable to the growth of credit.

C. LACK OF INNOVATIONS IN AFRICAN FINANCIAL MARKETS

The litany of problems with African financial systems usually includes "thin" money, capital, and financial markets with few institutions and instruments, conservative standardized lending practices based on the value of the collateral, detrimental regulations, etc. Existing institutions, instruments, and practices are not capable of allocating resources and risk over time, space, and projects. Government-owned banks, subsidized lending programs, and regulated credit allocation have proven ineffective. African financial systems not only need to expand in size and depth, but also to become more responsive to local conditions.

While there has been some experimentation in African financial markets in recent years, change has been slow to come. In contrast, there has been rapid innovation in the financial markets of the industrialized countries in the 1960s and 1970s that was reinforced by deregulation and international integration in the 1980s. There is still debate about what stimulated the innovation in developed financial systems. The most common explanations for innovation are binding regulations or increased competition. These, and other factors that are believed to have stimulated financial innovation in developed countries, are lacking in African financial markets.

Repression or Innovation? Dynamics of Financial Market Development

Researchers, following McKinnon and Shaw, have devoted a great deal of attention to the damage done by financial "repression" in developing countries. Low regulated interest rates, high reserve requirements, selective credit controls, and other regulations reduced the profitability of intermediation and slowed the growth of financial sectors in developing countries. Low profit margins on intermediation services also have been blamed for the conservative lending practices and unwillingness of financial institutions to innovate. (For example, see Fry, 1978.)

"Repression" has been blamed for lack of innovation in developing countries, but deposit rate restrictions in a period of

21

high inflation are considered the major cause of innovation in U.S. financial markets in the late 1960s and 1970s. New instruments and institutions were developed to test and circumvent financial market regulations. Kane posited a "regulatory dialectic" with financial institutions innovating to circumvent regulations and regulators respond with new regulations. The American public also became more sophisticated in liquid asset management under inflation and demanded new financial products. By the late 1970s the American regulatory framework had been undermined by new institutions and instruments so that markets either had to be reregulated or deregulated. Legislation reducing the controls on American financial markets was passed in 1980 and 1982. Therefore binding interest restrictions were one of the most important factors behind the dynamic experimentation and innovation in U.S. financial markets in the 1970s and deregulation in the 1980s. This is opposite of the relationship posited between interest rate restrictions and innovation in developing countries.

It is not clear why binding regulations led to innovation and deregulation in developed economies but stagnation in developing countries. One obvious possibility is that regulations are successfully circumvented with weak Central Bank enforcement. Another possibility is that many of the larger financial institutions are government owned, with different mandates and objectives.

There have been a few examples of new institutions or new instruments used in Africa in recent years. Examples of new institutions can be found in the growth of nonbank financial institutions and resulting competition in Kenya since 1980. Innovation in Kenyan financial markets may have been triggered when required capital standards were not enforced. This substantially reduced the fixed cost of entry. So in a sense, the Kenyan experience was a response to the information that a regulation was not binding rather than innovating around a regulation.

Market Structure

It has been argued that competition from outside the conventional banking system in the United States led to innovation. Kolari and Zardkoohi argue that innovation was stimulated by "new competition" from nonfinancial firms providing financial services. Later there was generalized competition with innovation of products, services, and delivery systems taking place among depository and nondepository institutions and nonfinancial firms separately as well as jointly (Kolari and Zardkoohi, 1987, p. 16).

There are few competitors in African financial markets. Many banking systems are oligopolistic, frequently with multinational banks dominating the sector. There is at least one government-owned commercial bank in most countries, but very few privately owned domestic banks. There are usually significant barriers to entry and few potential applicants. Few countries allow companies to go off-shore to borrow, and there are not organized equity market

22

alternatives to debt financing. Competition is limited and unlikely to stimulate innovation.

Schumpeterian Innovation

Bhatt posits a Schumpeterian version of innovation in Indian capital markets. Schumpeter believed that innovation was introduced by the leadership of New Men, setting up a New Firm, and with a New Plan. Bhatt argues that financial innovation came from new entrepreneurs with different technology and expertise as well as financial instruments. Bhatt does not attempt to explain which factors trigger the entrance of new players but lists several preconditions for the emergence of financial innovations: a climate of trust and confidence among market participants; monetary stability; no legal or customary obstacles, particularly with regard to informal credit markets. Bhatt feels that innovation is most likely to come from the informal sector because the intimate connection with clients makes it easier to recognize new opportunities and lowers transaction costs and risk of experimentation. Specialized services from informal credit markets are then adopted by larger financial institutions. Bhatt observes that most innovation is spontaneous but can be induced by policy intervention or reform that is either cost and risk reducing. Examples of cost and risk reducing government interventions are deposit insurance, credit guarantees, insurance schemes, and government subsidies for new technology or for opening a new branch, etc. Policy reform to encourage innovation includes getting rid of interest rate ceilings and credit controls (Bhatt, 1987, p. 47).

Informal credit markets frequently evolve contractual arrangements to compensate for incomplete markets. There have been some attempts to use practices of informal credit markets in Africa, particularly in cooperative credit programs. For example, there are unsecured group lending programs in Malawi. The group discipline is complemented with repayment discipline to qualify for continuing access to credit. The savings and credit cooperatives, such as found in Kenya, that motivate savings with access to credit rather than paying interest are another adaptation of informal rotating savings clubs. But while the cooperative system has used some mechanisms found in informal markets, it is hard to find overlap between the banking systems and informal markets. It may be because there are no incentives for the banking systems to lend to the traditional sectors, because the informal contractual arrangements cannot be easily adapted, or because informal credit markets are thin in many areas of Africa.

Informal Credit Markets

Little information is available on informal credit markets in Africa, except for the widespread communal savings clubs. Most areas do not have a specialized indigenous money-lending class and most informal flows of credit are within the extended family. The flow of funds within the family and friendship network may be extensive. Hyden argues that the social and economic organization,

23

which he terms the "economics of affection" plays an important role in basic survival, social maintenance, and development. The social support system performs some credit and insurance functions. Sharecropping and linked production-credit arrangements seem to be rare. Rather than concluding that informal credit is limited to the extended family and social circle, it may be safer to generalize that there is little documentation on the informal credit markets. A few studies documented some informal or supplier credit activities.

Imperfect and Incomplete Markets

The spatial and structural characteristics of many areas limit the options on financial contracts. Imperfect factor markets, especially for land and labor, make complex contracts difficult in Africa. Markets for risk sharing and intemporal allocation are incomplete which has immediate consequences for financial intermediation. In addition labor and land markets are 'imperfect' which has consequences for production, investment, and intemporal allocation. Communal tenure precludes using land collateral. This makes it difficult to identify suitable collateral or collateral substitutes. Many countries have linked the seasonal agricultural production credit to the operations of a parastatal marketing board. Donors have asked African countries to privatize marketing so monopoly marketing boards will not be able to enforce repayment. The spatial characteristics, especially in rural areas, make unsecured lending programs very risky. Monitoring and collection are costly with low population density and high transportation costs. Therefore the spatial and structural characteristics, especially in rural areas, make it hard to design new contracts.

Uncertain Property Rights and the Legal System

The costs and risks of financial innovation are lower with enforceable contract law and secure property rights. Uncertainty about property rights and the legal system, in general, increases the cost and risk of financial innovation. Unpredictable judicial rulings reduce the incentives for any bank to test property rights on new contracts. The incentives for financial innovation in small markets may be low anyway because established legal precedent on a contractual arrangement can rarely be patented.

Imperfect Information

Information is very costly in most African economies. Reporting requirements, accounting and auditing standards, and market information systems are generally poorly developed. As is well known asymmetrical information, when borrowers know more about their ability and willingness to repay, can cause market failures.

Financial intermediation plays a role in information generation and processing for the economy, but this function is not well developed in Africa. The costs of information gathering may be prohibitive outside the narrow circle of repeat clients.

Demand

Another possibility is that the demand for financial services is limited to a narrow range of instruments, reducing the incentives for innovation. Patrick highlighted the distinction between demand-following and supply-leading financial development. In the demand-following case, development of other sectors of the economy leads to an increase in demand for financial services and development of financial institutions. Effective demand is evidenced after growth in real output and modernization of the traditional economy. Therefore the development of financial markets lags behind some other sectors. In the case of supply-leading development, financial institutions transfer resources from traditional, nongrowth sectors to modern sectors, and the financial institutions play a role in promoting entrepreneurial activities in the modern sector. Supply-leading financial institutions search out and encourage modern ventures. Patrick uses the British banking system of the late eighteenth and early nineteenth centuries as an example of demand-following development because of the passive role played by the banks. Many of the banks in Eastern and Central Africa are patterned after British banks.

Several studies on capital markets in Africa discuss the lack of demand for financial services as inhibiting the development of financial markets. Many of these early studies mentioned lack of demand from the banks but did not discuss the pattern of demand from alternative indigenous credit institutions. There may be little confidence in financial institutions to meet credit needs.

The demand for financial services is related to the demand for investable funds. Gulhati and Datta discuss the possibility that the decline in investment in the late 1970s in eastern and southern Africa was due to strains on absorptive capacity, reflected in lack of projects, shortages of trained personnel, emergence of bottlenecks, and delays in decision making. (Gulhati and Datta, 1983, p. 15; Gulhati, Ravi and Gautam Datta. "Capital Accumulation in Eastern and Southern Africa." World Bank Staff Paper No. 562, 1983.)

The credit allocation pattern in most African countries has been very slow to change. Most African banks, especially in East Africa, still lend primarily to finance trade, even though African economies experienced severe balance of payments difficulties during the international recession of the early 1980s. Imports were curtailed as foreign exchange became scarce. For most countries, both the value and volume of exports declined, suggesting a decline in the demand for external trade finance from the commercial banks. Most economies have undertaken at least some policy reforms, but it is not clear yet whether demand, or even domestic relative prices, has reflected policy changes. Given the relative prices, regulatory distortions, and risk there may be a dearth of safe profitable lending opportunities. If policy reforms were perceived as being unsustainable, expectations may not change

25

and the demand for credit may not have increased in other sectors.

Technological Change

There has been rapid technological progress in information processing and communications which offered significant cost savings for some financial transactions and services in developed countries. Some of the new technology used in the financial markets of developed countries might be adapted in poorer countries. Some information processing technology is divisible and therefore transferable, e.g. microcomputers, and has been adopted by some banking systems in Africa. (e.g. KCB had a computerized accounting system for several years and NBK and the Central Bank in Kenya have adopted one within the last three years.) Given the shortage of skilled personnel to work with the computers and the high cost of imported components and software, it is an open question whether the adoption of new technology actually reduces costs.

Conclusions

Some of the theories posit innovation as a response to a change in the incentive structure such as restrictions that become binding, a change in relative prices in the economy, technical changes that change production costs, while other theories rely on the human factor as in the Schumpeterian theory, or like Miller argue that it seems to be a coincidence of forces that are not clearly understood.

D. THE INFORMAL SECTOR AND INFORMAL CREDIT MARKETS

The informal sector is a common phenomenon in most Third World countries and provides a substantial portion of employment, goods and services, and credit to the urban and rural economies. Although our focus here is on informal credit markets, it is impossible to study them in isolation from the formal sector, in general, and specifically from the formal financial sector. Usually, the informal market thrives around the formal sector and is heavily influenced by it. We have surveyed a number of articles on this subject which provide a glimpse at this symbiotic relationship, and at its internal functioning both in Africa and in other Third World countries.

A number of articles analyze informal credit markets by focusing on the informal sector of selected countries. The informal sector is usually defined as consisting of very small units engaged in the production and distribution of goods and services, which has provided the main alternative for people who are unable to find employment in agriculture or the formal urban sector. Informal sector activities are predominantly in tertiary activities, and despite the informal sector's contribution to employment generation, earnings in this sector are very low. Governments can assist the informal sector to generate capital from within and to expand despite generally unfavorable market and policy environment. One of the ways that

26

governments usually assist the informal sector is through channeling credit to it. The problems usually encountered are finding an appropriate delivery system and convincing formal sector institutions to make sufficient resources available. Even if these credit constraints of the informal sector were surmounted, other policies are usually called for. These include finding an appropriate mechanism for channeling other services to the sector like training, technology and market information. (Cf. Sethuraman.)

The informal credit markets of West Africa have been more closely analyzed than perhaps any other African informal markets (e.g. by Sonia Hammam in her study for USAID). East African capital markets, which have been the focus of a number of programs designed to expand their activities, have also been studied empirically by such scholars as Paul Vitta.

India is another area where capital markets have been the object of study (e.g. T. Timberg and C.V. Aiyar). The conclusions there are most interesting, since the informal sector there is fairly well developed and highly visible. Informal financial market intermediaries in India finance much trade in certain commodities and capital needs of small scale producers. Despite rapidly increasing bank credit for small scale industrial units, most of these units find it necessary to go into the informal market, if only during their busy periods. The rates in the informal financial markets are generally higher than the bank lending rates, but there is great variety in rates and forms of lending. The operating margins (the transactions costs and bad debt experience in these markets) are superior to the banks. They benefit from lower information search, overhead and reserve maintenance costs.

The articles surveyed are primarily empirical studies designed to give us insights into specific regions. Given this it may be difficult to derive conclusions which are consistent over region or for that matter time. Furthermore, the nature of informal markets makes data gathering and analysis difficult, thus any generalization that can be made should be regarded as tentative. Another impediment to our fully understanding these markets is the fact that complex socio-anthropological factors govern their behavior. Thus a comprehensive analysis would require skills from other social sciences.

Nonetheless, a few conclusions can be made about the informal sector:

--Informal markets are closely linked to the formal sector; they provide goods and services primarily to the informal sector, however, they do serve as a conduit for formal sector production to economically unsophisticated or deprived groups. They also receive market signals from the formal sector which sets the basis for prices, interest rates, and other costs in the informal markets.

27

--The informal sector suffers from many constraints such as low skills, poor market information, credit shortages, and unsophisticated technology. The only factor in abundance is labor which is primarily unskilled and low paid. This is primarily the result of the other constraints.

--Credit in the informal financial markets is generally provided at a high cost to the borrower. These high costs are rarely justified because of the shortterm nature of credit, localized markets, familiarity with these markets, low default rates, and practically nonexistent processing costs.

Policies designed to boost the informal sector should take into account the following recommendations:

--Specific studies should be carried out on different informal sectors that are to be recipients of assistance because of the unique conditions that may exist.

--Indigenous mechanisms of the informal sector should be utilized whenever possible in a concerted effort to mobilize credit and savings to (and from) the informal sector. Thus, the best features of the informal credit markets should be incorporated in any project development plan. Assistance agencies should work with informal and semi-informal institutions, such as cooperatives and social groups. If this is not feasible competing with the informal market should not be ruled out to lower borrowing costs.

--Greater stress should be placed on fostering financial innovations in the informal sector. These are especially necessary if formal sector institutions are to effectively reach the informal markets.

--Finally, credit is not the only constraint that the informal sector suffers from and should supplied in a comprehensive package designed to eradicate the other impediments to growth at the grassroots level.

E. THE FRANC ZONE

A majority of the ex-French colonies in West Africa has retained close economic links with France through their membership in the Franc Zone. The zone consists of two unions, the West African union of Cote d'Ivoire, Senegal, Niger, Mali, Benin, Burkina, and Togo and the central African union of Cameroon, Gabon, Congo, Central African Republic, Chad, and Equatorial Guinea. The basic features of the monetary union between the member countries and vis-a-vis France are the following:

--the common currencies of the unions are pegged at CFA 50 to a French Franc.

--the freedom of internal transfers, whereby capital transfers from one country to another, are unregulated, and transfers from one currency to the other are unlimited.

28

--exchange regulation harmonization according to the French regulations for all external financial transactions.

--the pooling of foreign exchange reserves of the member countries in the operations account of the French Treasury.

The operations account is the fundamental mechanism for the functioning of the monetary union. The operations account records as credits all the foreign exchange earned by each member country's central bank outside its currency zone. It also records as debits each central bank's currency expenditures outside its currency zone. At least 65% of the member country's central bank external reserves should be denominated in French Francs in order for the CFA Franc to be freely convertible. Furthermore, the French treasury grants overdraft facilities on each operations account which allows the member countries to draw French Francs. However, certain safeguard clauses become operative when the foreign exchange reserves are equal or smaller than 20% of deposits. There is also a provision whereby if the operations account becomes depleted, the central banks must draw on all possible sources of external reserves and other sources before resorting to the French Treasury's assistance. In the event that a member country borrows from its central bank (which in turn reduces its reserves with the operations account), this credit is limited to 20% of the previous year's revenue.

The franc zone has become an issue of considerable interest to various researchers especially in the context of the structural adjustment policies that the member countries are to the French franc. Studies have been conducted to determine whether (FF) the imbalances between France and the rest of the world that lead to the fluctuations in the FF vis-a-vis other currencies are usually in line with the imbalances in the franc zone countries. In particular, monetary developments have been studied in the context of a fixed exchange rate regime, since monetary developments are the channel for affecting the overall price level and thus the real exchange rate. A striking conclusion was reached by Kathie Krumm, who finds that FF responses to imbalances in France are not in line with the imbalances in the franc zone countries after calculating the real exchange rates over the last 15 years. Without sufficient real exchange rate adjustment in the face of the negative shocks, the economies either had to squeeze expenditures without changing the composition of those expenditures or had to finance the continuing deficits through direct external borrowing or indirect borrowing through the operations account. Krumm's examination of domestic credit developments over the same period revealed that rather than a contraction in monetary growth relative to trading partners in response to negative shocks, the franc zone countries shored up their economies by encouraging public enterprise borrowing, slowing down payments of parastatals to the private sector and increasing external borrowing. The problem, Krumm concludes, is the inability of the central bank to exercise sufficient control due to structural and institutional shortcomings.

The relationship between franc zone countries and France has been of major interest to dependency theorists. One of these, Guy Martin, feels that financial and monetary dependency is itself one of the main elements of the economic dependency of third world countries. If these states had been able to pursue independent monetary policies during the last two decades, they would not have suffered the distortions of the French economy and would have had greater control over savings and credit policies in their countries. The devaluations of the FF have adversely affected both the prices of major West African traded goods and the value of the foreign exchange deposits in the central banks. Another negative effect of the FF devaluations has been the effect on external amortization and interest payments of the member states. Furthermore, high rates of French inflation have been imported and adversely affected the cost of production and general price levels in these West African countries. Martin argues that the credit policies followed by the franc zone states have been extremely conservative and stifled local development. Low interest rates have contributed to marginal savings and capital flight especially in light of the free movement of capital provisions in the monetary union agreements.

These criticisms notwithstanding, economic growth in the franc zone countries have been higher over the last two decades than in other sub-Saharan countries. This is the result of the study ("Evaluating Participation in an African Monetary Union: A Statistical Analysis of the CFA Zone") done by S. Devarajan and J. de Mello for the World Bank's Development Research Department. After reviewing the potential benefits and costs for developing countries' participation in a monetary union, this paper has provided a simple assessment of the performance of the CFA franc zone during the period 1960-82. When comparisons were made for the entire period the results were sensitive to which of the eleven Cenery-Syriquin type of country classification schemes used. When the comparison of the zone is extended to other sub-Saharan countries, Devarajan and de Mello found that their growth is higher. Comparisons made of different periods (floating exchange rate, supply shocks and greater autonomy in setting monetary policy within the franc zone) yielded different results. The final conclusion made by these researchers was that the results cast doubt on the preoccupation that the monetary union is not functioning adequately. In fact, the results lend support to the view that the discipline imposed by union participation was helpful for adjustment during the period of generalized floating and supply shocks.

F. IMPLEMENTING FINANCIAL REFORMS

Coordination and implementation of financial liberalization programs are now recognized as major problems. Timing of policy reforms is an issue because of the lag in response after markets are decontrolled, market imperfections, adjustment costs, and externalities. With many possible reform strategies, policy-makers want to choose the one with the lowest adjustment costs for the economy. Relative adjustment costs will depend on the political, institutional, and economic characteristics of a

country so it is difficult to "liberalize by formula." However there are issues that are common across countries e.g. the welfare effects of partial reform, the speed of liberalization, the sequencing of reforms, and the relationship between liberalization and stabilization.

Macroeconomic Stabilization and Economic Liberalization

A distinction can be drawn between liberalization and stabilization problems. Liberalization refers to moving from controls to greater reliance on market forces while stabilization refers to correcting macroeconomic imbalances. Stabilization usually involves a program of fiscal control when the source of the problem is inflationary finance or aggregate demand control when financed by unsustainable levels of external borrowing. Therefore stabilization is related to the government or the intertemporal budget constraints. Liberalization means removing controls generating discrepancies between economic signals and the opportunity cost of resources and correcting relative prices.

Some countries, including countries under IMF programs, have attempted to undertake liberalization programs during periods of macroeconomic instability. However, it is considered desirable to achieve macroeconomic stability before attempting decontrol of markets. Most authors agree that fiscal control is a precondition for full liberalizing of the domestic financial sector so that the government is not dependent on an inflation tax.

Sequencing

If the economy is decontrolled gradually, decisions most be made on the order of liberalizing different markets. The choice will depend on the linkages among the capital and current accounts, domestic financial markets, the government sector, and the traded and nontraded sector and the effects of policy reforms.

There is a case for coordinating liberalization of the current account and reform of financial markets. Since financial markets allocate investment funds, efforts to liberalize the financial sector must consider investment incentives. In most cases, it will be desirable to first liberalize trade and goods markets so that relative prices correctly reflect longer-run investment incentives as a guide for bank allocation of credit. But this must be balanced against the arguments for decontrolling goods and financial markets at the same time since financial markets need to be capable of supporting the change in domestic relative prices. Balassa reinforced the interrelationship between successful trade and capital markets liberalization. The domestic capital markets need to be liberalized to permit new investments to flow into export sectors as trade is liberalized. Similarly, trade must be liberalized to allow the efficient use of resources when domestic capital markets are liberalized.

Another reason for concern about policy sequencing is that liberalization of other markets will effect the performance of the banking sector. Changing relative prices from trade or goods market liberalization may decrease profitability and asset values in previously protected activities. The banks may incur high loan losses when relative prices change and collateral may no longer cover the value of the loan in the event of default. If profitability falls, banks may not be willing to support new ventures even when financial markets are liberalized and may not be able to compete with off-shore banking when capital accounts are liberalized. It has been argued that domestic capital markets must be liberalized before the capital account of the balance of payment to prevent an outflow of capital to respond to higher international interest rates. However, domestic banks may have difficulty competing with international interest rates if other reforms have inflicted large losses.

While there are important linkages that must be considered in a financial sector reform, it is not possible to set general guidelines about the sequencing of liberalization among trade, domestic capital, and labor markets. The country-specific interaction of long-term investment signals and restrictions on bank allocation of credit will determine the order of liberalization. Distortions in capital markets can either reinforce or offset import restrictions, depending on whether the distortions channel capital into or away from the protected activities. If the restrictions channel capital away from the protected activity, easing the restriction before liberalizing trade will increase the misallocation of resources in the economy and lower welfare. Therefore one cannot generalize about whether either a partial or a complete liberalization in the capital market should precede, accompany, or follow a partial liberalization of the goods market.

Partial Liberalization

It is not possible to establish theoretically, but there is some agreement that partial reforms in the financial sector can be welfare-improving even in the absence of reforms in other sectors. Most partial reform programs call for allowing greater flexibility in interest rates and lending patterns and reducing restrictions on the profitability of commercial banking.

Interest rate liberalization will have to consider the provisions of outstanding contracts. Some institutions may not have the option to raise interest rates on outstanding loans even if market rates change. This will be even more of a problems for development banks and parastatal lending institutions which have term loans. In addition, some funded projects may not be viable at higher decontrolled interest rates so policy reform must consider the repercussions on the banks and the private sector.

There are even more difficult problems with interest rate decontrol in countries with "thin" financial markets. Few governments are willing to allow an oligopolistic banking sector to determine market rates. There are also a host of problems that

37

can arise in countries with "open" capital accounts, e.g. the wide fluctuations in international interest rates can be transmitted into the domestic economy.

Past Experience with Financial Market Liberalization and Applicability to Africa

A few countries, e.g. Brazil and Korea, have successfully liberalized financial markets. Attempted reforms in Argentina, Chile, and Turkey were not as successful and the reasons are still open for debate. For example Krueger called for research on whether problems arose from competition between banks or interaction between the liberalization of financial markets and that of the foreign exchange market. There is only limited empirical work available on financial sector reform programs in other areas, especially in the Southern Cone countries, and the issues may be different in the African economies.

First, the experience of the Southern Cone countries may not be directly relevant because those economies tend to have more excess capacity than the African economies. The financial requirements of increasing productive capacity with term finance or equity capital are not as amenable to price adjustments. The African countries need to extend the range of institutions and instruments.

Second, the financial markets of Africa are very thin with few institutions and few instruments. There may be justifiable hesitancy to decontrol domestic financial markets with oligopolistic banking sectors. Furthermore, depending on the "openness" of the economy, decontrolled interest rates may reflect the large fluctuations of interest rates in international capital markets.

Third, the "imperfections" in African factor markets are going to make it difficult for the banking system to expand services to new clients and activities. This will be especially true for areas with uncertain property rights and communal land tenure systems. In agriculture, governments have been able to provide credit with less security because repayment was assured through monopoly marketing agencies. For example, many countries have linked seasonal agricultural production credit to the operations of a parastatal marketing board. It is not clear what security arrangements or repayment mechanisms can be substituted if agricultural marketing is privatized and decoupled from the credit function. In such cases, financial sector reform will have to be coordinated with reforms in marketing.

Fourth, the francophone African countries have less flexibility in adjusting exchange rate and financial policies. Financial sector liberalization within a currency union will involve a different set of issues than for nonaffiliated countries.

The need for reform in many areas of the economy and thin "imperfect" markets are going to make financial sector reform in Africa complicated. Unfortunately there are few examples and poor documentation of financial sector reform attempts in Africa.

G. ISLAMIC BANKING

Among the alternatives to traditional commercial banking, one which has gained currency in recent years is Islamic banking. The most striking feature of Islamic is the rejection of the notion of fixed interest on lending or deposits, based on the Islamic injunction forbidding riba (usury). The issue of Islamic banking arises frequently in dealing with Africa's development needs, as Islamic banking touts itself as being particularly responsive to the financing needs of a society with a large rural sector, where small entrepreneurs find it difficult to obtain financing from the formal financial sector.

The literature dealing with Islamic banking is still in the early stages of theoretical development, despite the fact that a number of Islamic financial institutions (notably the Islamic Development Bank at Jeddah) have tried to interest economists and financial theorists in the subject. Indeed, the Jeddah-based International Center for Research in Islamic Economics was set up primarily to promote research on the application of Islamic dogma to economic issues. Of special importance to the Center is the setting up of a theoretical framework that could corroborate the viability of interest-free banking at the institutional and societal levels. The reasons for the relatively slow development of literature on the subject of Islamic banking are:

- In Western academic (and business) circles, Islamic banking stills suffers from the stigma of being perceived mostly as a cosmetic arrangement designed to cater to the sensitivities of a small segment of the market, or to attract funds from wealthier Islamic states to poorer ones.

- Because the version of Islamic banking that is regarded as most exportable to less developed countries is closely associated with a political outlook that is traditional, conservative, and generally pro-Saudi, this has disposed a number of scholars against it on ideological grounds.

Before we proceed further we should specify that there are several forms of banking which claim to be "Islamic", the only thing they have in common being a more or less rigorous aversion to fixed interest. Thus revolutionary Iran claims to run its banks on Islamic principles, while Turkey, which is staunchly committed to a capitalist economic order, has encouraged the development of banks that operate on the PLS (profit-loss-sharing) principle.

The basic prototype for conventional Islamic banking, is an Islamic bank that was established in 1963 in Mit-Ghamr, an

34

Egyptian Delta town. The bank operated on an interest-free basis, and was largely intended as an experiment to verify the viability of the interest-free principle in banking in today's environment. Its success resulted in a host of imitators, so that the total number of Islamic banks in existence today was estimated at 31 in 1984. Of these, the following were in Africa:

- Al-Baraka Sudan Islamic Bank, Khartoum, founded 1984
- Al-Baraka Tunisia Finance House, Tunis, founded 1984
- Saudi-Tunisia House of Finance, Tunis, founded 1984
- Faisal Islamic Bank of Egypt, Cairo, founded 1977
- Faisal Islamic Bank of Guinea, Conakry, founded 1982
- Faisal Islamic Bank of Senegal, Dakar, founded 1982
- Faisal Islamic Bank Sudan, Khartoum, founded 1977
- International Islamic Bank for Investment and Development, Cairo, founded 1982
- Islamic Cooperative Bank, Port Sudan, Dungola, Halfa and Atbara, founded 1983
- Nasser Social Bank, Cairo, 1971

In addition, the banking system in Sudan moved toward Islamic banking as the government introduced legislation to Islamize banking there. Also, the Somali government is studying a proposal for the setting up of an Islamic bank, although the prospects of that happening are currently considered remote.

Despite the strong presence of Islamic banks in Africa, little study has been done of their role in Africa per se. The only exception has been in the case of Sudan, where a number of papers have been written about the role of Islamic banking there. On the whole, however, the main trend in the literature has been to focus on the theory of Islamic banking, using an abstract approach (usually in historical context), or to discuss the notion of an Islamic economic order, and what it means for monetary and financial administration.

The literature on Islamic banking can be divided into two basic groups of publications. The first is publications issued by institutions committed to the propagation of Islamic banking, notably the International Center for Research in Islamic Economics and the Iranian Central Bank, or publications specializing in Islamic thought (like the Karachi-based Journal of Islamic Banking and Finance). These vary in quality, and often (but not always) exhibit an ideological bias that causes them to depart from the mainstream approach in economic thinking. The second is articles published in well-known scholarly publications. These tend to adopt a more objective approach toward the subject, and focus instead on an examination of how an Islamic banking institution can function subject to the injunctions of the sharia (Islamic legal code), and what that would imply for monetary control. The focus is often on the financing needs of developing countries, and while Africa is specifically considered as the focus of any of these studies, their conclusions have obvious implications for the applicability of Islamic banking to African countries.

35

Our review will focus on the second group of articles, first because they are more readily accessible and more widely quoted worldwide, and second because the approach they represent commands consideration in the literature on development finance.

On the whole, the verdict on the applicability and usefulness of Islamic banking in developing economies is still divided, and the issue is likely to be clouded by ideologically motivated polemics for some time to come. The consensus appears to be that Islamic banks can indeed function and be profitable under most circumstances. What is not clear is whether their behavior is particularly conducive to resource mobilization or, more importantly, to an efficient or desirable resource allocation, and whether monetary control is not weakened in an Islamic banking system.

A notable divergence between the theory and practice of Islamic banking lies in the low proportion of profit-and-loss agreements in Islamic banks' portfolios. Islamic banks tend to derive far more income from lease agreement, which carry little risk. This implies that Islamic banks' supposed provision of greater financial support for agricultural and industrial projects through profit-and-loss- participation arrangements has little basis in reality, as the long gestation periods involved in such operations make it difficult for Islamic banks to show quick financial success to their shareholders and depositors; instead trade financings, which yield earnings in the short term, are preferred. This finding, corroborated by the evolution of many Islamic banks' income statements and by their explicit movement away from PLS loans, greatly diminishes the supposed allocative superiority of Islamic banks.

As for the compatibility of Islamic banking with monetary and fiscal control, that has generated some discussion, both specifically in the cases of Sudan, Iran and Pakistan, and more generally in a theoretical context. Iqbal and Mirakhor have found that the restriction on fixed interest borrowing had to be waived in Iran in the case of the government borrowing from the nationalized banks, while in Pakistan's case not all government borrowing is handled through noninterest modes. Hamdi cites a Bank of Sudan report on bank policy that suggests an alternative to the use of interest rates as a monetary tool (for selective credit controls), namely requiring different ratios of participation for the commercial banks in their mushraka operations for different sectors.

III. SUMMARY AND PROPOSED APPROACH TO EMPIRICAL INVESTIGATION

Our discussion of the issue of the role of the financial sector in economic development started with the repressed financial markets hypothesis propounded by McKinnon and Shaw, and the financial development models that have been derived from it. The McKinnon-Shaw argument is that distortions of financial

36

prices (notably the interest rate and foreign-exchange rates) result in a repression of the financial system, and hence of the contribution it can make to the development process. This hypothesis effectively narrows the focus of financial development to the financial sector itself, suggesting that reform of the financial sector (particularly lifting controls that have distorted financial prices) is a crucial first step toward allowing the financial sector to perform its role in the development process.

Our subsequent examination of other issues judged pertinent in a study of financial development in the context of the sub-Saharan African countries under investigation suggests that the McKinnon-Shaw position is too narrow, since it overlooks:

- Other macroeconomic factors that affect savings and investment behavior (income levels and distribution, expectations, the range of available financial versus real assets, attitudes to borrowing and lending, etc.)
- The specific financing needs of the rural sector and its potential for savings mobilization
- The shortcomings of the formal financial sector in some countries and its institutional incapacity to serve the needs of the informal sector, both rural and urban
- The need for financial sector innovations, entailing the development of new contractual relationships between established financial institutions and segments of the population currently not served by them
- The necessity of seeing financial sector reform as part and parcel of an overall sequence of stabilization and adjustment policies, and of timing financial sector reform appropriately so that it does not prove counterproductive.

In applying these premises to our empirical study of the 11 sub-Saharan African countries in our sample, account must be taken of a number of limitations. In particular:

- The recent literature has not produced anything resembling a consensus that could give rise to an incontrovertible, or indeed straightforward, approach to financial development
- One of the limitations of recent research on financial development is a narrow focus, so that most treatises and empirical studies concern themselves with one element of credit markets, financial sector regulations, or financial sector reform.
- The literature thus far produced on the subject of financial development has rarely been focused on sub-Saharan Africa, the Far East and, in the case of financial sector reform, Latin America being the more usual fields of study. Nor are the generalized conclusions of the literature necessarily applicable to sub-Saharan Africa, or more specifically to the countries we are examining, given their special characteristics alluded to earlier. Indeed, the literature allows for few cross-country comparisons.

Nonetheless, we feel that it would be highly profitable to formulate a basic framework of analysis for the countries we propose to examine that would incorporate the salient points raised in recent studies of financial development. To accomplish this, we propose to do the following:

- To analyze the aspects of the financial sector and the environment in which in operates to which different current schools of thought attach importance
- To integrate the various elements being studied into a coherent structure that illustrates how the various elements relate to each other
- To emphasize the institutional and other characteristics that are of special importance in the countries with which we are dealing, and demonstrate how different theoretical approaches fare in light of these characteristics

Our study of each of the individual countries will thus focus on the following:

- Macroeconomic and non financial factors that affect the performance of the financial sector
- The structure of the formal financial sector and its relationship to:

    - o The government
    - o The formal private sector
    - o The parastatal sector
    - o The semi-formal sector (cooperatives, credit unions, etc.)
    - o The informal sector (both rural and urban)

- The regulation to which the financial sector is subject, and the extent to which it is repressive or leads to distortions of financial prices
- An evaluation of the performance of the financial sector, particularly of its allocative efficiency, its ability to mobilize savings and its adaptability to innovations
- Recent monetary and fiscal policies, as well as structural adjustment programs, and what they have implied for the financial sector
- The scope for financial sector reform, and how it fits into the scheme of needed reforms elsewhere in the economy

From this we hope to derive the following:

- An assessment of the extent to which financial sector reform is needed at present in each country
- An assessment of the extent to which such reform is feasible at present given:

    - o The state of the economy as a whole
    - o The attitude of the government

58

- Specific recommendations for projects promoting financial sector reform in these countries where such projects are feasible that would stress:

    - o The promotion of innovations
    - o The building and consolidation of institutions
    - o The diffusion of new skills
    - o Increased information about investment opportunities and savings potential
    - o A program of assistance tied to the implementation of necessary financial sector reform in the appropriate sequence

- Specific recommendations for follow-on studies that should be undertaken in those countries where such studies are warranted.

BIBLIOGRAPHY

MCKINNON-SHAW

Cho, Yoon Je (1984), On the Liberalization of the Financial System and Efficiency of Capital Accumulation Under Uncertainty (Stanford University: PhD Thesis, 1984).

Fry, Maxwell (1977), "Financial Instruments and Markets" in Conferencia Internacional sobre Economia Portuguesa, 11 a 13 Outubro de 1976 edited by the German Marshall Fund of the United States and the Fundacao Calouste Gulbenkian (Lisbon: Fundacao Calouste Gulbenkian, 1977), pp. 189-208.

_____(1982), "Models of Financially Repressed Developing Economies" in Problems and Policies in Small Economies edited by Bimal Jalan (London: Croom Helm, 1982), pp. 185-207.

_____ and Raburn M. Williams (1984), American Money and Banking (New York: Wiley, 1984).

Galbis, Viecente (1974), "Financial Intermediation and Economic Growth in the LDCs" (Washington, DC: International Monetary Fund, DM/74/103, October 1974).

Gurley, John G. and Edward S. Shaw (1960), Money in a Theory of Finance (Washington, DC: Brookings Institution, 1960).

Kapur, Basant K. (1976), "Two Approaches to Ending Inflation" in Money and Finance in Economic Growth and Development: Essays in Honor of Edward S. Shaw edited by Ronald I. McKinnon (New York: Marcel Dekker, 1976), pp. 199-221.

_____ (1983), "Optimal Financial and Foreign-Exchange Liberalization of Less Developed Economies," Qaurterly Journal of Economics 98(1), February 1983, pp. 41-62.

Krugman, Paul (1978), "Interest Rate Ceilings, Efficiency and Growth: A Theoretical Approach" (New Haven: Yale University, Department of Economics, 1978).

Mathieson, Donald J. (1979), "Interest Rates and Monetary Aggregates during a Financial Reform" (Washington, DC: International Monetary Fund, DM/79/95, December 1979).

_____ (1980) "Financial Reform and Stabilizaton Policy in a Developing Economy," Jounral of Development Economics, 7(3), September 1980, pp. 359-395.

McKinnon, Ronald I. (1973), Money and Capital in Economic Development (Washington, DC: Brookings Institution, 1973).

Molho, Lazaros E. (1986), "Interest Rates, Saving, and Investment in Developing Countries: A Re-examination of the McKinnon-Shaw Hypothesis," International Monetary Fund Staff Papers, 33(1), March 1986, pp. 90-116.

Shaw, Edward S. (1973), Financial Deepening in Economic Development (New York: Oxford University Press, 1973).

RURAL CREDIT MARKETS

Adekanye, Tomilayo O. (1983), "Agricultural Credit in Africa: Implications of the Nigerian Experience", Agricultural Administration (U.K.) No. 14, pp. 203-211 (1983)

Adewunmi, Wole (1980), "Money and Capital Markets in Nigeria's Economic Development", University College of North Wales, Institute of European Finance, Financial Research Papers (U.K.) No. 17. pp. 1-22 (May, 1980)

Adeyemo, Remi (1983), "Credit as an Input in Marketing: a Study of the Nature and Use of Credit by Food Marketers in Anambra state of Nigeria", Savings and Development (Italy) No. 1, pp. 63-73 (1983)

_____ (1982), "Strategies for Improving Agricultural Credit in Nigeria", Savings and Development (Italy) No. 1, pp. 85-96 (1982)

Adeyemo, Remi and Adekum-Sarbraw, Kwaku (1985), "Examination of Agricultural Loan Administration in Ghana: a Case Study of the Agricultural Development Bank of Ghana", Nigerian Journal of Financial Management (Nigeria) 4, No. 1/2, pp. 21-27 (June/Dec., 1985)

Amore, Giordano dell' (1973), "Agricultural Credit in African Countries", Cassa di Risparmio delle Provincie Lombarde, 97pp. (Milan: 1973)

Belloncle, Guy (1968), "Le Credit Agricole dans les Pays Afriques d'Expression Francaise au sud du Sahara", Organisation des Nations Unies pour l'Alimentation et l'Agriculture (FAO), 162 pp. (Rome: 1968)

Chidebelu, Angus N. (1983), "Problems of Formal Smallholder Credit in Southeastern Nigeria", Agricultural Administration (U.K.) Vol. 13, pp. 1-9 (May 1983)

Cline, Carol Richards and Wieland, Peg (1982), "Trade and Credit in the Middle East and North Africa: Problems and Resolutions", Chase Trade Information Service, Chase Manhattan Bank, 368 pp. (New York, N.Y.: 1981)

Coleman, Gilroy (1987), "Monitoring a Rural Credit Project in Ethiopia", Agricultural Administration and Extension (U.K.) 24, No. 2, pp. 107-127 (1987)

Due, Jean M. (1983), "Update on Financing Smallholders in Zimbabwe, Zambia and Tanzania", Savings and Development (Italy) No. 3, pp. 261-277 (1983)

Duncan, Kweku Akyene (1987), "Rural Banking", West Africa (U.K.) No. 3630, pp. 661-662 (April6, 1987)

Earlander, Hildegard, and Mezger, Dorothea (1969), "Entwicklungsbanken und -gesellschaften in Afrika; Grunddaten zu 95 Afrikanischen Finanzierungs-Institutionen", Weltforum Verlag, 211 pp. (Munchen: 1969)

"Le Financement de l'Agriculture par le systeme Bancaire: le Cas des Etats de la Zone d'Emission de la Banque des Etats de l'Afrique Centrale", Banque des Etats de l'Afrique Centrale, Etudes et Statistiques (Cameroun) No. 117, pp. 303-312 (Dec., 1984)

Fontana, Francesco (1983), "Credit and Agriculture in the Economy of Madascar", Savings and Development (Italy) No. 3, pp. 243-259 (1983)

Ihimodu, Ifeyori I. (1981), "Financing the Green Revolution in Nigeria: Some Lessons From Kwara State", Savings and Development (Italy) No. 4, pp. 271-288 (1981)

Ike, Don N. (1986), "Problem of Loan Default in Nigerian Agriculture: an Economic and Financial Analysis", Indian Journal of Economics (India) No. 66, pp. 409-422 (Jan., 1986)

Lele, Uma J. (1979), "The Design of Rural Development: Lessons from Africa", published for the World Bank by Johns Hopkins University Press, 246 pp. (Baltimore: 1979)

41

Maren, Michael Paul (1987), "Small-scale Credit for Africa's Use", Development Business: the Business Edition of Development Forum (International) No. 221, pp. 1,3 (April 30, 1987)

Martin, David (1981), "Transition in Smallholder Banking in Kenya; Evidence from Rural Branch Bank Loans", Journal of Developing Areas (U.S.) No. 16, pp. 71-86 (Oct. 1981)

Mauri, Arnaldo (1977), editor, "Mobilization of Household Savings: a Tool for Development", Cassa di Risparmio delle Provincie Lombarde, 219 pp. (Milan: 1977)

"Methodes de Mobilisation de l'Epargne Rurale dans les Pays Africaines", Ministere des relations exterieures, cooperation et developpement, Direction des politiques de developpement; 373 pp. (Paris: 1983)

Monu, Erasmus (1982), "Innovation in Small-scale Farmer Credit Administration in Northern Nigeria", Agricultural Administration (U.K.) No. 10, pp. 255-263 (Aug., 1982)
-Describes the credit/savings scheme included in an experiment in agricultural development in the Giwa district of Kaduna State, Nigeria.

Nankumba, J.S. (1982), "Stallfeeder Credit Programme in Malawi: a Study With Special Reference to the Lilongwe Land Development Programme", Agricultural Administration (U.K.) No. 9, pp. 103-114 (Feb. 1982)

Nowak, Maria (1986), "Nouvelles Approches en Matiere d'Epargne et de Credit Rural pur l'Afrique au Sud du Sahara", Caisse centrale de cooperation economique, Division des etudes generales, 48 pp. (Paris: 1986)

Nweke, Felix I. and Obi, Ajanihu A. (1982), "Problems of Administration of Smallholder Credit in Nigeria; the Case of Anambra State", Quarterly Journal of International AGriculture (Germany, Fed. Rep.) No. 21, pp. 173-179 (Apr./June, 1982)

Oller, Walter G. and Okoye, Emmanuel O. (1983), "Appraisal of the Agricultural Credit Performance of Nigerian Commercial Banks, 1970-1980", Agricultural Administration (U.K.) No. 13, pp. 137-152 (1983)
-This paper assesses the performance of Nigerian commercial banks in providing credit to agriculture.

Oludimu, Olufemi (1984), "Training of Agricultural Credit Staff in Nigeria: an Insight", Savings and Development (Italy) No. 3, pp. 257-266 (1984)
-The present paper sets out with the objective of investigating the nature of training opportunities available to agricultural credit staff in Southern Nigeria, and the implications of such training schemes.

42

_____(1983), "Focus on Agricultural Credit Financing in the Rural Economy of Nigeria--a Case Study of Oyo Region of Nigeria", Nigerian Journal of Financial Management (Nigeria) 2, No. 2, pp. 25-36 (Dec., 1983)

_____(1982), "Linking Saving with Credit: Agricultural Financing in S.W. Nigeria", Savings and Development (Italy) No. 1, pp. 41-52 (1982)

Osuntogen, Adeniyi and Oludimu, Olufemi (1981), "Extending Agricultural Credit Through Public Institutions in Nigeria", Savings and Development (Italy) No. 2/3, pp. 139-154 (1981)

_____ and Adeyemo, Remi (1981), "Mobilization of Rural Savings and Credit Extension by Pre-cooperative Organizations in Southwestern Nigeria", Savings and Development (Italy) No. 4, pp. 247-261 (1981)

Owusu, Kwame Opoku and Tetteh, William (1982), "Experiment in Agricultural Credit: the Small Farmer Group Lending Programme in Ghana (1969-1980)", Savings and Development (Italy) No. 1, pp. 67-84 (1982)

Oyatoye, E.T.O. (1983), "Economic Appraisal of Small Farmers Credit Schemes: a Cost Study of Western Nigeria", Savings and Development (Italy) No. 3, pp. 279-292 (1983)

Sanni, T.A. (1986), "Vector Autoregression on Nigerian Money and Agricultural Aggregates", Canadian Journal of Agricultural Economics (Canada) No. 34, pp. 67-85 (March 1986)
-Employs vector autoregression (VAR) to study the effects of domestic credit conditions proxied by money supply (M1 and alternatively M2), on domestic prices and agricultural trade. The author concludes that the empirical results strongly support the contention that money matters for the agricultural sector of Nigeria.

Seibel, Hans Dieter (1986), "Rural Finance in Africa; the Role of Informal and Formal Financial Institutions", Development and Cooperation (Germeny, Fed. Rep.) No. 6, pp. 12-14 (1986)

Stewart, Bonnie Ann (1984), "Cooperatives and Agricultural Development: a Case Study of the Credit and Cooperatives Union of the Republic of Niger", Journal of African Studies (U.S.) No. 11, pp. 66-73 (Summer, 1984)

Swamy, M.R. Kumara (1984), "Financial Management Analysis of Loan Administration in the Nigerian Economy--a Call for Seasonal Agricultural Credit Policy Formulation", Nigerian Journal of Financial Management (Nigeria) 3, No. 1, pp. 30-58 (June, 1984)

Takirambudde, Peter (1981), "Law, Commercial Bank Credit and African Entrepreneurship: the Case of Swaziland", Savings and Development (Italy) No. 4, pp. 233-245 (1981)

Vasthoff, Josef (1986), "Small Farm Credit and Development; Some Experiences in East Africa with Special Reference to Kenya", Weltforum Verlag, 144 pp. (Munich, 1968)

Von Pischke, John D. and Rouse, John (1982), "Selected successful experiences in agricultural credit and rural finance in Africa", World Bank, Agriculture and Rural Development Department Working Paper, no. 47, 31 pp. (Washington, D.C.: July, 1982)

_____ and Rouse, John (1981), "Selected successful experiences in agricultural credit and rural finance in Africa", World Bank, Agriculture and Rural Development Department Working Paper, no. 69, 31 pp. (Washington, D.C.: Dec., 1981)

_____(1983), "Selected successful experiences in agricultural credit and rural finance in Africa", Savings and Development (Italy) No. 1, pp. 21-44 (1983)
-Examples in Morocco, Kenya, Cameroon, Zimbabwe and Malawi of partial success in rural finance are described.

Wilson, Frank Arnal and Amann, Victor F. (1975), editors, "Financing Rural Development: Proceedings of the Eastern Africa Agricultural Economics Society Conference, University of Zambia, Lusaka, Zambia, May22-25, 1974", The Society, 277 pp. (Kampala, Uganda: 1975)

LACK OF INNOVATIONS

Financial Markets in Developing Countries

Fry, Maxwell J. (1978), "Money and Capital or Financial Deepening in Economic Development?" Journal of Money, Credit, and Banking, 1978.

McKinnon, Ronald J. (1973), Money and Capital in Economic Development. Washington, D.C.: The Brookings Institution, 1973.

Patrick, Hugh T. (1966), "Financial Development and Economic Growth in Underdeveloped Countries." Economic Development and Cultural Change, Vol. 14, Jan. 1966, pp. 174-189.

Shaw, Edward S. (1973), Financial Deepening in Economic Development. New York: Oxford University Press, 1973.

Virmani, Arvind. (1981), "The Nature of Credit Markets in Less Developed Countries: A Framework for Policy Analysis." Domestic Finance Study No. 71, Development Economics Department, World Bank, 1981.

Innovation

Scherer, F.M. (1984), Innovation and Growth: Schumpeterian Perspectives. Cambridge,MA: The M.I.T. Press, 1984.

44

Financial Innovation

Bhatt, V.V. (1987), "Financial Innovations and Credit Market Evolution." Economic and Political Weekly, Vol. 22, No. 22, May 30, 1987, pp. 45-54.

Desai, M. and W. Low. (1982), "Financial Innovations: Measuring the Opportunity for Product Innovation." London School of Economics, Economic and Social Research Council, Discussion Paper No. A. 58. (Desai and Low discuss the microeconomics of innovation in retail deposit markets. They use a product characteristic approach. The motivation for innovation is latent demand for a product. Federal Reserve Bank of St. Louis. Financial Innovations: Their Impact on Monetary Policy and Financial Markets. Boston: Kluwer-Nijhoff Publishing Co., 1984.

Papers from the 7th Annual Conf. held in 1982.

Greenbaum, Stuart I. and C.V. Heywood. (1973), "Secular Change in Financial Service Industry." Journal of Money, Credit, and Banking, 1973, pp. 571-603.

Greenbaum, Stuart I. and Bryon Higgins. "Financial Innovation" in Benston, George J. (ed.) Financial Services. Englewood Cliff, NJ: Prentice-Hall, Inc., 1983.

Howard, D. H. and K.H. Johnson. (1982), "Financial Innovation, Deregulation, and Monetary Policy: The Foreign Experience." in Federal Reserve Bank of San Francisco. Interest Rate Deregulation and Monetary Policy, 1982.

Kane, Edward J. (1981), "Accelerating Inflation, Technological Innovation, and the Decreasing Effectiveness of Bank Regulation". Journal of Finance, Vol. 36, May 1981, pp. 355-367.

Kane posited a "regulatory dialectic" with financial institutions innovating to circumvent regulations and regulators respond with new regulations.

Kolari, James and Asghar Zardkoohi. (1987), Bank Costs, Structure, and Performance. Lexington, MA: Lexington Books, 1987.

Kolari and Zardkoohi discuss competition from nonbanks in stimulating innovation in American banks.

Miller, Merton H. (1986), "Financial Innovation: the Last Twenty Years and the Next." Revue de la Banque, (Belgium) Vol. 50 No. 7, Sept. 1986, pp. 35-42. also published in Journal of Financial and Quantitative Analysis, (U.S.) Vol. 21, Dec. 1986, pp. 459-471.

While major impulses for innovation seems to come from regulation and taxes, the process has not been fully explained yet.

Silber, S. (1983), "The Process of Financial Innovation." American Economic Review, Vol. 73, May 1983, pp. 89-95. (check

45

pages may be 89-100)
Proposes a framework to classify recent financial innovations in developed financial markets.

Financial Innovation in Africa

Mauri, Arnaldo. (1983), "Potential for Savings and Financial Innovation in Africa." Savings and Development, (Italy) No. 4, 1983, pp. 319-37.
Focuses on savings mobilization in the African economies.

Financial Innovation in Developing Countries

Krieger, Ronald A. (1986), "Experts Warn that Innovations Pose Hazards for Financial System in Developing Countries." IMF Survey, International Edition, Vol. 15 No. 14, July 14, 1986, pp. 210-213.
Notes for a conference on Innovation in Capital Markets sponsored by the Institutional Investor.

Llewellyn, David T. (1985), "International Financial Intermediation." Arab Banker; Jl. of the Arab Bankers Association, (U.K.) Vol. 5, May/June 1985, pp. 12-15.
Discusses the role of banks in developing countries and dynamics of financial innovation.

Financial Innovation in Asia

Cheng, Hang-Sheng. (1986), Financial Policy and Reform in Pacific Basin Countries. Lexington, MA:, Lexington Books, D.C. Heath and Company, 1986.

Financial Innovation in Japan

Suzuki, Yoshio. (1983), "Interest Rate Decontrols, Innovation, and the Effectiveness of Monetary Policy." Bank of Japan Monetary and Economic Studies, Vol. 1 No. 1, June 1983, pp. 1-30.

_____ (1983), "Changes in Financial Asset Selection and the Development of Financial Markets in Japan." Bank of Japan Monetary and Economic Studies, Vol. 1 No. 2, Oct. 1983, pp. 29-53. (discussed the effect of an artificially low regulated interest rate on the decline in indirect (intermediated) finance to direct finance (purchasing securities)

_____ (1986), "Comparative Study of Financial Innovation, Deregulation, and Reform in Japan and the United States." Bank of Japan Monetary and Economic Studies, Vol. 4 No. 2, Oct. 1986.

_____ (1986), Financial Innovation and Monetary Policy: Asia and the West. University of Tokyo, 1986.

146

Financial Innovation in Europe

Vaciago, Giacomo. (1985), "Financial Innovation and Monetary Policy: Italy versus the United States." Banca Nazionale del Lavoro. Rome, Dec. 1985, pp. 309-326.

Credit Rationing

Riley, John G. (1987), "Credit Rationing: A Further Remark." American Economic Review, Vol. 77 No. 1, March 1987, pp. 224-227.

Stiglitz, Joseph E. and Andrew Weiss (1981), "Credit Rationing in Markets with Imperfect Information, Part I." American Economic Review, Vol. 71, June 1981.

_____ (1987), "Credit Rationing: Reply." American Economic Review, Vol. 77 No. 1, March 1987, pp. 228-231.

Production Relations in Africa

Binswanger, Hans P. and Mark R. Rosenzweig (1982), "Behavioral and Material Determinants of Production Relations in Agriculture." Discussion Paper No. 5, Research Unit, Agriculture and Rural Development Department, World Bank, June 1982.

Details the consequences of incomplete markets for risk and intertemporal allocation, with special emphasis on agricultural areas of developing countries.

Robertson, A.F. (1987), The Dynamics of Productive Relationships: African Share Contracts in Comparative Perspective. Cambridge: Cambridge University Press, 1987.

There is a long-standing debate on the relationship between market structure and incentives to experiment and innovate. This debate can be traced back to an early argument that the incentives for research were greater for monopolists.

INFORMAL SECTOR

Primary Sources

Sethuraman, S.V. (1985), "The Informal Sector in Indonesia: Policies and Prospects:, International Labour Review, Vol. 124, No. 6 (1985), pp. 719-735.

S. V. Sethumanam defines the informal sector as it operates in Indonesia and its relationship to the formal sector. The article also outlines ways of assisting the informal sector, and more specifically of developing its role in employment generation.

Vitta, Paul B. (1985), "The Informal Sector in Eastern Africa: Selected Policy-related Issues", Africa development, Vol. 10, No.4 (1985), pp. 59-71.

41

Vitta focuses on the advantages that the informal sector enjoys. The article also makes recommendations for providing assistance to the informal sector.

Hamam, Sonia, "The Informal Sector in W. Africa",

Hamam analyzes the basic characteristics of the informal sector in a number of West African countries. She dispels some of the myths about the high costs incurred by informal credit markets, and identifies areas where formal intervention may benefit the informal sector.

Timberg, Thomas A., and Aiyar, C.V. (1980), "Informal Credit Markets in India, Domestic Finance Studies 62 (Washington, D.C.: IBRD, 1980)

Timberg and Aiyar discusse the role of of informal credit markets in India, where the are vital in financing trade. The comparative advantages and particular characteristics of informal credit circuits are outlined.

FRANC ZONE

Barry, Mamadou Alpha (1984), "Malie, Fin de l'Autarcie", Jeune Afrique (France) No. 40, pp. 48-49 (May 24, 1984)
-Apres de serieux efforts de redressement economique, le Mali vient d'obtenir aon admission au sein de l'Union monetaire ouest-africaine. Mais le remplacement du franc malien par le franc CFA risque d'entrainer un derapage des prix.

Bhatia, Rattan J. (1985), "THe West African Monetary Union: an analytical review", IMF Occasional Paper No. 35 (Washington, D.C.: 1985; 58 pp.).

Brasseul, Jacques and Engelhard, Philippe, "Integration Monetaire et Developpement Economique: le Cas de la Zone Franc", Mondes en Developpement (France) No. 52, pp. 505-528; with English summary, p. 487.

Central Bank of the West African States (1966), "Treaty, agreements, conventions and statutes establishing the West African Monetary Union and the Central Bank of the West African States"; (Paris: 1966; also available in French).

Connolly, Michael (1985), "On the Optimal Currency Peg for Developing Countries", Journal of Development Economics (Netherlands) No. 18, pp. 555-559 (Aug., 1985)
-Suggests that while crawling peg exchange rates, whether active or passive, can be a valuable device for maintaining external balance in an inflationary environment, they may be inferior to a common currency area in a number of ways, particularly with respect to monetary stability and monetary integration. Evidence is presented on the stability of the

French franc zone in West Africa and on the now defunct dollar zone in Latin America. With a reply by John Williamson, p. 561-562.

Connors, Thomas Aquinas (1979), "Balance-of-Payments adjustment in the West African Monetary Union", thesis (PhD), photocopy, University of Michigan (Ann Arbor, Michigan: 1979; 149 pp.)

Cunha, Antonio-Gabriel M. (1984), "CFA franc zone; the other side ofthe coin", Africa Report (U.S.) No. 29, pp. 59-62 (Sept./Oct., 1984)
-Concludes that as Africa's debt crisis grows, membership in the zone may be more of a burden than a benefit.

Crum, David Leith (1984), "Mali and the U.M.O.A.: a Case-study of Economic Integration", Journal of Modern African Studies (U.K.) No. 22, pp. 469-486 (Sept., 1984)

Devarajan, Shantayanan (1986), "Evaluating Participation in African Monetary Unions", Discussion Paper, (Washington, D.C.: World Bank, 1986)
-S. Devarjan and J. De Mello examine the growth record of CFA franc zone countries and conclude that that have fared better than other sub-Saharan African country. They attribute this to superior monetary discipline within the UMOA group.

Diallo, Yoro (1978), "France and the West African Monetary Union: a Frank Appraisal of the Franc Zone", thesis (MS), typescript, St. Mary's Graduate School of Business (Moraga, California: 1978; 102 pp.)

"Finances, Echanges et Monnaie des Pays d'Afrique Noire: Cameroun, RCA, Congo, Cote d'Ivoire, Dahomey, Gabo, Haute-Volta, Mali, Mauritanie, Niger, Senegal, Tchad, Togo", Ediafric la Documentation Africaine, Paris (1975)

Krumm, Kathie, "Adjustment in the Franc Zone: Focus on the Real Exchange Rate", monograph.
-Kathie Krumm's monograph, "Adjustment in the Franc Zone: Focus on the Real Exchange Rate" written for the World Bank's Country Policy Department assesses the behavior of the real exchange rate in light of the macroeconomic adjustment process for the non-oil exporting franc zone countries in response to negative real shocks.

Martin, Guy (1986), "The Franc Zone, Underdevelopment and Dependency in Francophone Africa", Third World Quarterly (U.K.) Vol. 8, pp. 205-235 (Jan., 1986) -Guy Martin's paper, "The Franc Zone, underdevelopment and dependency in Francophone Africa" argues that the franc zone, far from contributing to the economic development and independence of its African member states, is largely instrumental in perpetuating and increasing the these states' underdevelopment and dependency on France.

Mladek, J.V. (1964), "Evolution of African Currencies, Part I:

The Franc Area", Finance And Development (International) Vol.1, No. 2, pp. 81-88 (Sept., 1964)

_____ (1966), "Currency Unions--pro and con", Finance And Development (Internatinal) Vol. 3, No. 2, pp. 92-98 (June, 1966)
-Concludes that while the countries of Western Europe and Central America ponder on whether their currencies should be united, countries in Africa can offer some practical lessons based on experience with currency unions.

Peterson, Enoch Wesley Frost (1975), "French Economic Relations with the West African Monetary Union", Woodrow Wilson Association, monograph series in public affairs no. 7 (Princeton, New Jersey: 1975; 51 pp.)

"Statistiques Economiques et Monetaires; U.M.O.A." (1987), Banque Centrale des Etats de L'afrique de l'Ouest, Notes d'Information et Statistiques (Senegal) No. 356, pp. 1-26 (Jan., 1987)

"Steps to Monetary Union" (1982), West Africa (U.K.) No. 3381, pp. 1373-1377 (May 24, 1982)
-Discusses the monetary union which is one of the objectives of the Economic Community of West African States.

Yansane, Kerfalla (1984), "Controle de l'Activite Bancaire dans les Pays Africains de la Zone Franc", Librairie Generale de Droit et de Jurisprudence, 385 pp. (Paris: 1984)

"La Zone Franc et l'Afrique" (1977), Ediafric (France); Numero speciale du bulletin de l'Afrique noire; 376 pp. (Paris: 1977)

"La Zone Franc et l'Afrique: Benin, Cameroun, RCA, Congo, Cote D'Ivoire, Gabon, Haute-Volta, Mali, Niger, Senegal, Tchad, Togo", Ediafric, Paris (1979)

IMPLEMENTING FINANCIAL REFORMS

Balassa, Bela (1982), "Structural Adjustment Policies in Developing Economies." World Development, Jan. 10, 1982, pp. 23-38.

_____ (1986), "Comment" in Choksi, Armeane M. and Demetris Papageorgiou. Economic Liberalization in Developing Countries. New York: Basil Blackwell for the World Bank, 1986, pp. 60-64.

Bhagwati, Jagdish N. and Anne O. Krueger (1974), Foreign Trade Regimes and Economic Development. National Bureau of Economic Research, 1974-8.
The nine country studies published, included one was on African country, Ghana. This study covered the reform attempt in Ghana in 1966-71 when quantitative restrictions were converted to tariffs. The study focused on the relationship between liberalization and growth, and did not

50

place special emphasis on the issues of sequencing.

Choksi, Armeane M. and Demetris Papageorgiou (1986), Economic Liberalization in Developing Countries. New York: Basil Blackwell for the World Bank, 1986.

Edwards, Sebastian (1984), The Order of Liberalization of the External Sector in Developing Countries. Princeton, N.J.: Princeton Essays in International Finance, No. 165, Princeton University, 1984.

Edwards, Sebastian (1986), "The Order of Liberalization of the Current and Capital Accounts of the Balance of Payments." in Choksi, Armeane M. and Demetris Papageorgiou. Economic Liberalization in Developing Countries. New York: Basil Blackwell for the World Bank, 1986, pp. 185-216.

Edwards, Sebastian (1986), "Comment." in Choksi, Armeane M. and Demetris Papageorgiou. Economic Liberalization in Developing Countries. New York: Basil Blackwell for the World Bank, 1986, pp. 32-35.

This is a response to the paper by Anne Krueger.

_____ (1987), "Sequencing Economic Liberalization in Developing Countries." Finance and Development, Vol. 24 No. 1, March 1987, pp. 26-29.

Edwards (1987) offers a few generalization on the series of reforms in stabilization/liberalization programs. The first guideline is that domestic interest rates can be raised only after the fiscal deficit is under control so that the government is no longer dependent on inflationary finance. But domestic interest rates must be raised before international capital controls can be lifted to prevent an outflow of funds. The second principle is that the current account should be liberalized before capital controls are related. The current and capital accounts should not be liberalized at the same time because of conflicting incentives. Liberalizing the capital account will lead to an appreciation while liberalizing current account needs depreciation.

_____ and Mohsin S. Khan (1985), "Interest Rate Determination in Developing Countries: A Conceptual Framework." IMF Staff Papers, Vol. 32, No. 3, Sept. 1985, pp. 377-403.

Theoretical framework to examine the interaction of international and domestic factors in determining interest rates in developing countries with empirical tests from Colombia and Singapore.

_____ and Sweder van Wijnbergen (1986), "The Welfare Effects of Trade and Capital Market Liberalization." The International Economic Review, Vol. 27, No. 1, Feb. 1986, pp. 141-148.

Edwards and van Wijnbergen (1986) propose the use of the following analytical devices: the effects of a capital

account liberalization in the presence of trade distortions can be analyzed as a transfer problem. They suggest that the opposite scenario i.e. the opening of the trade account in the presence of capital account restrictions can be done in an intertemporal optimization model of an open economy.

Krueger, Anne O (1986), "General Issues in Economic Liberalization." in Choksi, Armeane M. and Demetris Papageorgiou. Economic Liberalization in Developing Countries. New York: Basil Blackwell for the World Bank, 1986, pp. 15-31.

Lal, Deepak (1986), "Comment." in Choksi, Armeane M. and Demetris Papageorgiou. Economic Liberalization in Developing Countries. New York: Basil Blackwell for the World Bank, 1986, pp. 217-218.

Lal differs from the conventional view of sequencing because he argues for floating exchange rates, allowing capital inflows during the liberalization process, and finally because he feels that the fundamental problem is credibility of government policies not the technical questions of sequencing.

_____ (1987), "The Political Economy of Economic Liberalization." The World Bank Economic Review, Vol. 1, No. 2, Jan. 1987, pp. 273-299.

Lal differs sharply with most other analysis on the timing of reform. He argues that a sharp reduction in the government role and a strong departure from past policies is politically necessary. (Lal, 1987)

McKinnon, Ron (1986), "Comment." in Choksi, Armeane M. and Demetris Papageorgiou. Economic Liberalization in Developing Countries. New York: Basil Blackwell for the World Bank, 1986, pp. 219-223.

McKinnon argues against allowing capital inflows during trade liberalization because capital inflows will appreciate the domestic currency and thus hurt the prospects for exporting industries and import-competing firms and make it hard for them to adjust to the removal of protection.

Michaely, Michael (19986), "The Timing and Sequencing of a Trade Liberalization Policy" in Choksi, Armeane M. and Demetris Papageorgiou. Economic Liberalization in Developing Countries. New York: Basil Blackwell for the World Bank, 1986, pp. 41-59.

Michaely discusses three issues extensively: speed of implementation; stages of policy implementation including policy instruments to gain more control for a multi-stage liberalization and treatment of different sectors; import liberalization in relation to other policy reforms.

Mussa, Michael (1986), "The Adjustment Process and the Timing of Trade Liberalization." in Choksi, Armeane M. and Demetris Papageorgiou. Economic Liberalization in Developing Countries. New York: Basil Blackwell for the World Bank, 1986, pp. 68-124.

Musa developed a two-sector two-factor model to investigate

the speed of liberalization given different assumptions of market imperfects or deviations between social and private costs.

ISLAMIC BANKING

Khan, Mohsin S. (1986), "Islamic Interest-Free Banking: A Theoretical Analysis," Staff Papers, International Monetary Fund (Washington), Vol.33 (March 1986), pp. 1-27.

Khan presents a theoretical model of an interest-free banking system consistent with Islamic priniciples. The article develops a model for an Islamic banking system, providing a rationalization for Islamic banking in a neoclassical setting. The author argues that, seen in such a setting, Islamic banking is not particularly alien to Western economic thinking, as it corresponds closely to a form of banking often proposed in the literature on banking reform in the United States, namely banking based on equity participation. He then shows that an Islamic banking system would be relatively more stable (in a strict mathematical sense) than a traditional one in the face of shocks that result in banking crises and disruption of the country's payment mechanism.

Iqbal, Zubair and Mirahor, Abbas (1987), Islamic Banking. Occasional Paper No. 49, (Washington, D.C.: IMF, 1987)

Iqbal and Mirakhor review theoretical aspects of an Islamic financial and banking system and its application in Iran and Pakistan, both of which have made attempts to bring their banking systems in closer conformity with Islamic principles. It then identifies the problems in the application of Islamic banking principles as stemming from the lack of a legal framework that unambiguously defines property rights and contract law in accordance with an Islamic banking system, the difficulty in developing non-interest-based sources of financing for government deficits, and the lack of adequate financial infrastructure, particularly trained bank staff and means of dealing with higher information and transaction costs to both the banks and their depositors in the absence of explicit interest rates.

Abdus-Shahid, Talib Siraaj (1986), "Interest, Usury and the Islamic Development Bank: Alternative, Non-interest Financing", Law and Policy in International Issues, Vol. 10, No. 6 (1986), pp. 1095-1136.

Abdus-Shahid provides an overview of the legal, religious and historical background of the Islamic banking system, and focuses in particular on the oprations of Islamic Development Bank, a Jeddah-based institution which operates primarily as an international project development bank. The article provides a detailed analysis of the banking transactions permitted according to the Islamic code and analyzes them in historical context. It discusses the evolution of early investment partnerships, both

unlimited (mufawada) and limited (inan) under Islam and explains the liabilities under both types of partnership. It then explains the commoner "mudaraba" contract operations, between an investor and of capital or merchandise and an agent-manager. It also details the forms of paper credit permissible under Islam, and variants of the mudaraba contract, namely musharika, allowing the investors and entrepreneurs to join together to finance ventures, qard al hasna, providing for interest-free consumption loans to bank's borrowers, ijara, or rental financing, and ijara wa iqtina, or lease-purchase financing.

Shaaeldin, Elfatih, unpublished monograph (1985).

Shaaeldin suggests that the size of the average loan extended by Faisal Islamic Bank Sudan has increased almost threefold from 1979 to 1982, and the explicit policy statements on the Bank's commitment to small artisans and producers disappeared from annual reports as early as 1983.

Hamdi, Abdul Rahim, unpublished monograph (1986).

Hamdi points to the advantages that Islamic banking enjoys vis-a-vis traditional banking in the context of a developing country, namely: an Islamic bank, being more of an equity-participant, has a greater stake in the success of operations it finances; an Islamic bank is more inclined to provide a very wide variety of social, economic and pure banking services, including zakat (alms), beneficial (or concessional) loans and advisory and insurance services; an Islamic bank has access to a segment of the population that would otherwise be averse to using banking services; and an Islamic bank is "institutionally" (i.e. internally) supervised for compliance to its moral and legal constraints, which makes it adaptable to fiscal and monetary regimes imposed by the state.

Niehaus, Volker (1985), "Principles, Problems and Perspectives of Islamic Banking", Intereconomics, (September/October 1985), pp. 233-238.

Niehaus provides a more succinct treatment of Islamic banking legal concepts, and discusses the pitfalls of Islamic banking in today's world. It pointed to the problems faced by the Geneva-based Dar al-Maal al-Islami, which had invested heavily in gold, and Kuwait Finance House, which had invested heavily in real estate. More to the point, it addresses the experience of Islamic banks in Sudan, which have come under attack for having too low a proportion of project finance which would aid development. The author concedes that the low proportion of profit-loss loans in Sudanese Islamic banks' portfolios diminished their supposed allocative superiority; however, the author notes, this is precisely because Islamic banks are not distinguishing themselves sufficiently from traditional banks, many of them simply adopting the catchy label of "Islamic".

Looney, Robert (1985), "Saudi Arabia's Islamic Growth Model --

Applications to Monetary and Banking Policy", Journal of Social, Political and Economic Studies, Vol. 10, No. 2 (1985), pp. 177-193.

Looney explains the limitations on Central Bank policy in the specific case of Saudi Arabia, where the inability to use the discount rate or open market operations as an instrument of monetary control (both being contrary to Islamic laws) has reduced the SAMA (Saudi Arabian Monetary Agency or Central Bank) to relying on reserve requirements as the sole major policy tool.

CHAPTER 2: COUNTRY STUDIES

A. GUINEA

1. MACROECONOMIC SURVEY

a. Introduction and Key Macroeconomic Problems

The death of Sekou Toure in 1984 marked the end of a political and economic era in Guinea. A group of army officers carried out a coup following Sekou Toure's death and established the Second Republic. Following 25 five years of extremely centralized economic management by the previous regime, the first three years of the Second Republic have been marked by far reaching economic reforms which have attempted to liberalize and diversify the economy of Guinea. These economic reforms have included a revamping of the foreign exchange regime, a complete restructuring of the financial sector, revocation of the central government's monopoly over internal and external trade, an attempt at rejuvenating the agricultural sector, and a slight increase in infrastructural investments. The new regime has also tried to grapple with Guinea's external debt situation by concluding a successful rescheduling of payments coming due in 1986, and appealing to the international community to support it in this endeavor.

Economic growth in Guinea over the last 25 years has been lower than the population growth rate of 3%. This has been the result of economic policies pursued by the Sekou Toure government which emphasized state control over the main sectors of the economy. The vestiges of this system that the present government is trying to grapple with are the following:

--an economy that is distorted toward the urban centers of the country because of a system of administered prices and a highly overvalued Guinean syli (25 sylis to the US dollar at end-1985, compared with nearly 400 sylis to the US dollar on the black market).

--government revenues which were heavily dependent on the mining enclaves (bauxite and alumina). These revenues were used to subsidize urban consumption of imported foods and consumer goods and support the extremely insolvent parastatals which undertook most of the industrial production and infrastructural investment. The vagaries of the international commodity market and the inability of the government to secure decent terms on its mining concessions from the Western multinationals and Soviet mining companies resulted in severe financial constraints.

--an open black market, created largely to supplement shortages due to the government's inability to capture sufficient foreign exchange, supplied goods which were smuggled or pilfered from official imports. The black market came to

56

supply nearly all of the urban sector's demand for sugar, cooking oil, rice and other consumer items such as gasoline and textiles.

--an inefficient state management system and financial constraints also hampered industrial production. The manufacturing sector, which was predominantly state owned, produced chemical products, textiles, construction materials, and included some agro-industries. Most of these units suffered from severe capacity underutilization due to the lack of imported spare parts, raw materials, excessive interference of the government in management, and from a lack of worker incentives.

--public sector service companies which came to be severely undermined by the private sector companies many of them operating illegally. The state was unable to provide reliable transport services between the interior and the coast while the state trading monopoly, IMPORTEX, was constrained by foreign exchange shortages and could not compete with the black market.

--a defunct official financial sector, where all the commercial banks, were state owned and in reality performed some of the functions of the central bank. They suffered from non performing loans (formerly extended to the insolvent parastatals), illiquidity, poor accounting practices, and gross overstaffing.

--an agricultural policy for subsidizing the urban economy through low producer prices and cheap imports of agricultural commodities and an inefficient marketing system which in turn provided severe disincentives to farmers. Thus, food crop production did not keep pace with the population growth and cash crop production (consisting of pineapples, coffee, and groundnuts) has declined drastically in the last two decades. Most of the produce of animal husbandry and forestry were exported to neighboring countries.

--an extremely low per capita income resulting from Guinea's dismal economic performance over the last 25 years. Per capita income in Guinea is estimated at $300 bearing in mind that different strata of the population subsist on a range of incomes. The vast majority (80%) of the population work in the agricultural sector at a subsistence largely as a result of low agricultural investment by the government, suppressed producer prices, and inefficient marketing arrangements.

--a low savings rate because of low incomes and high consumption patterns. Gross National Savings in 1985 at constant 1982 prices were around 6% of GDP while overall consumption accounted for nearly 90% of GDP. The growth of the parallel economy and black market exchange rate helped spur inflation which was officially estimated at around 15%-20% per annum during the early eighties, but was closer to 30%-50% in the unofficial economy. Inflation in turn encouraged consumption

which was also helped along by remittances sent home by the nearly one million Guineans living abroad. This was further exacerbated by the fact that the private sector under the First Republic distrusted the state banks, which were not only inefficient but at times arbitrarily expropriated and confiscated funds. Government savings were also basically non existent since most current revenue was spent on recurring expenditure and to support the deficits of the parastatals.

The economic situation that the Second Republic inherited is reflected in the external and fiscal deficits of Guinea. Government expenditures, which supported nearly 20% of the GDP, proved to be intractable, while the revenues the government received continued to decline over the last two decades. Although Guinea benefited from higher aluminum prices in the mid-seventies, for the most part mining revenues to the state have been fairly stagnant. Compounding this was the total inability of the government parastatals to increase revenues from domestic sources. Tax and custom duty receipts from enterprises in the industrial and service sectors declined as economic activity came to be dominated by the black market. Furthermore, non tax revenue transfers from the parastatals virtually disappeared; in fact, budgetary transfers to support the enterprises have constituted a massive drain on government resources.

With current expenditures and transfers constituting a large percentage of the overall receipts, little was left over for Guinean capital outlays. Thus, Guinea's accumulation of foreign debt went to largely finance infrastructural and parastatal in vestment, and resulted in an unsustainable external payments situation. Debt service ratios exceeded 30% of exports goods and services and thus had to be rescheduled by the present regime in 1986 after the Guinean government started to build up relatively large arrears.

Parastatal domestic borrowings from the state banks in the early 1980s accounted for nearly 99% of credit to the economy. Thus, the inability of the government to subsidize the public enterprises further led to the total collapse of the state banks in 1985. Because of bureaucratic incompetence and corruption, the black market took on a major role in determining the value of the currency, the availability of goods in the market place, and developed an informal credit market to finance its own activities. Although government could not control the black market it did block its entry into the productive sectors. Thus the black market was largely involved in short-term speculative and smuggling activities with few overall economic benefits such as employment, skills development, or institution building.

The Second Republic inherited this state of economic affairs from the Sekou Toure era. Given its goal to revive the economy through far reaching structural adjustments, it set four main development priorities.

--Foremost among these priorities was the need to reform the exchange rate system with the unification of the official and parallel rates. As a prerequisite for monetary reform, the government was determined to establish a solvent and efficient banking system.

--The new government saw the need to take several measures for improving the capacity and performance of the transport, power, water, and the social services sectors.

--As a means to revitalize the economy the government deemed it necessary to decentralize economic functions and create an appropriate environment for private sector development.

--The external finance situation was to be resolved through price incentives for diversifying exports and reducing food imports. Furthermore, the government appealed to the international community for both new funds and a rescheduling of old commitments.

The performance of the reform program so far has been in keeping with these initial objectives. In order to unify the exchange rate gradually, the Guinean government set into place a five phase program. Following the devaluation and the renaming of the currency (the new name is the Guinean Franc) early last year, a system of foreign exchange purchases with weekly auctions was instituted. Prices of certain selected strategic products were decontrolled for the purpose of real cost pricing and to introduce the first steps toward taxation of products and services provided by the parastatals. The price of rice was raised in the urban areas, while producer and import prices were aligned. Gasoline prices have been aligned to those in neigh-boring countries. Water, electricity, transport, postal, and telecommunications charges have been raised considerably to reflect the economic costs of the parastatals. Finally, the customs tariff system has been simplified with a 10% tax applicable to nearly all imports.

The government has also instituted major structural reforms. The major feature of this has been the liquidation of all non viable public enterprises and the rehabilitation of those having a long-term future. The latter group of companies has either partially or totally been sold to the private sector. All state banks were liquidated in 1985 and four private commercial banks have been established consequently. Three of these are similar to French banks while the fourth is an Islamic bank. The government also established a new credit policy to encourage savings and investment. Depositor interest rates were raised and a banks' interest rate was established on the Central Bank of Guinea's rediscount rates. The idea was to make interest rates positive so as to encourage financial intermediation; however, the acceleration of inflation due to the currency devaluation mandated by the structural adjustment program, interest rates fell well short of the inflation rate that ultimately materialized.

New lines of credit (in coordination with IDA, EEC and CCCE) have been opened on preferential terms for the small- and medium-sized enterprises and agricultural concerns. External debt management was greatly enhanced after the April 1986 Paris Club rescheduling. Guinea is undertaking negotiations with certain Eastern bloc and Arab countries and unsecured lenders for another rescheduling. Finally, new petroleum, mining, fisheries, and investment codes were promulgated during the last two years which have improved the environment for private sector participation in these sectors.

b. Implications of Key Problems for the Financial Sector

The reforms undertaken by the new regime have helped stabilize the economy. They have also given the correct signals to the private sector to take the lead in investment in productive ventures. Within this environment, the restructured financial sector has a greater chance of growth and viability. Nonetheless, it is still constrained by the structure of the economy inherited from the past. Specifically these are:

--The problem of marginal savings as a result of low capita incomes in most sectors of the economy persists. The growth of savings will have to await the development of agriculture once the pricing reforms take hold.

--Despite a severe reduction in government expenditures, the foreign exchange reform and other monetary measures, there is a persistence of medium to high levels of inflation. These coupled with low nominal deposit rates have continued the trend in negative real return on bank deposits. This has contributed to consumption over savings and to the aversion of the commercial banks to medium- or long-term credit.

--The private sector is extremely distrustful of the formal financial institutions created by the Second Republic. Greater interaction between the private sector and the commercial banks will help overcome this. Financial innovations will also be a key factor in spurring deposits.

--A general unfamiliarity with the activities of the private sector, the prospects for industrial growth and agricultural development- and certain infrastructural impediments have resulted in the commercial banks to lend primarily for short-term trade finance. The uncertainty of the market has also contributed to high intermediation fees charged by the commercial banks.

--The recent restructuring of the central bank has contributed to delayed and undeveloped regulations governing the financial sector.

2. THE FINANCIAL SECTOR

Guinea's financial system collapsed in 1985 following years of inflation and public sector mismanagement. At that stage the new Guinean government set in place a series of reforms with the help of the International Monetary Fund (IMF). What has transpired since then has been an attempt at starting over, and therefore, the picture that emerges from the discussion that follows on the financial structure should be viewed as tentative and continuously evolving. There are a number of changes still to be made; but these will have to await other macroeconomic developments or changes.

Institutions

The Central Bank of Guinea (BCRG): The BCRG has been entrusted with regulating the financial markets and carrying out the country's monetary policy. The BCRG, however, is still in the process of reorganizing and establishing guidelines for the commercial banks. In early 1987, the central bank established a policy for the refinancing of loans and a rudimentary interest policy. The banks' lending rates (rediscount rate plus 5%) have been set on the basis of the BCRG's rediscount rates (normal rediscount rate: 15%, preferential rate: 10%). Depositor interest rates (term deposits: 15% per annum minimum) have been raised and fixed according to the amount and term of the deposit. No guidelines have been provided to commercial banks with respect to lending activity and no reserve requirements policy have been set down.

Under close IMF supervision, the BCRG has been monitoring overall monetary growth and agreed with the IMF to control the amount of total outstanding credit to the economy. The central bank is responsible for attaining these overall ceilings, through control of liquidity in the system via selective access to refinancing or through the eventual establishment of reserve requirement applied to banks. This role has not really been actively pursued by the central bank (because of a lack of instruments) and thus not affected the small number of commercial banks. These banks have been financing their lending program out of their own resources.

The basic thrust of the Central Bank's regulations to control government borrowing indicates that the Guinean government would like to gain eventual membership into the UMOA (Union Monetaire d'Ouest Afrique - West African Monetary Union, sometimes referred to in English as WAMU) system. The Central Bank has been given control of the current Treasury accounts in agreement with the Ministry of Finance. Government borrowings from the BCRG are limited to 20% of the previous year's budgetary revenues. This provision matches policies in force in the UMOA system.

The other "franc zone" policy is the exchange rate statute which requires that all foreign exchange transactions between Guinean residents and non residents be either authorized by the BCRG

or conducted through an authorized agent of the bank which are mainly the local commercial banks. Central Bank authorization is required for Guinean residents to hold foreign exchange in accounts in Guinea or abroad. Residents must repatriate export and other revenues earned abroad with a period to be determined in implementing regulations, and all import and export transactions must be registered with authorized banks.

The aim of the reforms concerning foreign exchange is to achieve full convertibility with the franc zone. At present the government has been attempting to bring the large black market for foreign exchange under its control at market set rates and with the smoothest possible procedures. For the most part it has been successful in achieving this despite early instability in the parallel market as the regulations were being implemented.

The Commercial Banks: Guinea's experiment with private commercial banks is relatively new. During the Sekou Toure era all banks were state owned and 90% of their aggregate internal credit was to the inefficient and unproductive parastatals. By 1985 the Guinean government could not continue to support these bankrupt parastatals and thus the state owned banks were rendered insolvent as well. The military government abolished the old state banks. Consultants from the World Bank (financed under credit 1234-GUI) assisted the Central Bank prepare a liquidation plan with liabilities ranked by order of priority and specific schemes defined for repayment. Guidelines have also been prepared for the recovery of outstanding loans. Specialized Guinean teams for each bank have attempted to implement the liquidation program; bank employees, other than members of these teams, are to be transferred to the civil service reserve.

The new government allowed the establishment of three new commercial banks after 1985 in addition to an existing Islamic bank. The new commercial banks were created with the help of the multilateral agencies and foreign commercial banks. Guinea's commercial banks are the following:

--the Banque Internationale pour l'Afrique de l'Ouest en Guinee which opened in August 1985 was the first bank created during the Second Republic. The Guinean government has a majority holding (51%) in this bank, with the Banque Internationale pour l'Afrique de l'Ouest (BIAO) holding nearly a third of the shares, and the Geneva based Societe Financiere pour les Investissements et le Developpement en Afrique owning the rest. The bank is managed by the BIAO.

--the Banque Internationale pour le Commerce et l'Industrie en Guinee (BICI-GUI) and the Societe Generale de Banques en Guinee (SGBG), both created in early 1986 with foreign capital investments. The BICI-GUI had start-up capital of $9.1 million with $2.5 million coming from the IDA's Industrial Rehabilitation and Promotion Project (Credit 1234-GUI). This credit was provided to the Guinean government which owns 50% of the initial capital. The rest of the government's share was

financed by the European Investment Bank. The Guinean government is expected to sell half of its shares to private Guinean investors within two to three years. The foreign investors that have participated in this venture are the Geneva based Societe Financiere des Pays d'Outre-Mer (20% share divided among three investors: 10% for the Banque Nationale de Paris (BNP), and 5% each for the Banque Bruxelles Lambert and the Dresdner Bank) and 30% of mixed institutional ownership including the International Finance Corporation (IFC), the Caisse Centrale de Cooperation Economique (CCCE), the European Development Fund (EDF), DEG and the FAC. The BICI-GUI is managed by BNP staff. The BNP is expected to increase its ownership through the repurchase of the 30% ownership held by the bilateral and international investors. The international development agencies have been particularly interested in the BICI-GUI because its mandate calls for the support of small and medium-sized enterprises both in the rural and urban sector. The BICI-GUI plans to establish branches in Conakry and seven provinces over the next two years. It will also be the primary facilitator of industrial and agricultural credit and initially be largely responsible for credit operations to the public enterprises that have survived.

--The other bank started with foreign capital participation is the Societe Generale de Banque en Guinee (SGBG) which also opened in January 1986. The SGBG is jointly owned by private Guinean shareholders (45%) and by European banks (55%) led by the Paris based Societe Generale and including Credit Suisse, Banca Nazionale del Lavoro, and Bayerische Vereinsbank.

--the Masraf Faysal Al Islami Guinee, the only bank surviving the Sekou Toure era, is an Islamic bank established in 1983 as a joint venture between the Guinean government and Dar al-Mal Al Islami-Switzerland. This bank was largely set up with funds from Saudi Arabia.

Despite the initial enthusiasm for these private enterprises by the government and the international financial and donor community, some problems have materialized:

--The private sector banks have not undertaken much development related financing. Total institutional credit has been growing fairly rapidly since early 1986. From GF 1.6 billion in March 1986, credit expanded to GF 5 billion by early August and Nearly GF 6 billion by the end of August. It is estimated that by the end of 1986 credit outstanding had reached nearly GF 10 billion, just short of the IMF ceiling of GF 10.6 billion. Nonetheless, the BCRG estimates that 96% of outstanding credit consists of short-term commercial credit and only 4% of the credit was extended to industry.

--Most structural impediments to private sector productive investments may have been eradicated by the present government but the extremely weak condition of the private sector after

20 years of state monopoly cannot be expected to be surmounted in a short period.

--The business community is not the only section of the Guinean economy suffering from inexperience. The lack of experience of the banks themselves and their lack of knowledge of the local markets limits these banks' ability to identify projects, analyze their feasibility, or evaluate entrepreneur character and capabilities.

--Banks sense a genuine lack of investment opportunities especially since the nascent state of consumer markets can barely support higher levels of industrial production and investment. The private sector banks' are also waiting for more to be done by the government.

--Although the government has undertaken some serious reforms since it came to power, it has essentially not taken positive steps to encourage and create a private sector. Particularly there is a legal void surrounding the issues of collateral and guarantees.

For the most part the banks have been familiarizing themselves with the market through developing the safest business prospects, the trading community. Thus what little institutional credit that is extended is given to those with the most entrepreneurial expertise. This also offers the banks a quick turnover of funds at a reduced level of risk. However, the commercial banks, particularly BICI-GUI, do contend that they are in the process of identifying demand for credit in the productive sector of the economy. BICI-GUI claims that as of October 1986 it had in its pipeline, projects amounting to 55% of the foreign currency it manages. Nonetheless, over the medium term lending to agriculture will develop fairly slowly and be limited by the lack of familiarity with this sector. BICI-GUI acknowledges this despite its move to establish seven branches in the provinces during the next two years. In the industrial sector, the absence of a diversified industrial base and the uncertainty of the impact of the macroeconomic reforms on the economy will force the banks to adopt a wait and see posture.

It should be noted that small- to medium-sized enterprises will be eligible for substantial foreign currency credit programs. Three line of credit supplied by IDA, EEC, and CCCE have been opened on preferential terms (varying from 8%-13%) for the SMEs and for certain agro-industrial enterprises. These credits, however, will only finance the foreign currency component of new ventures. Most local enterprises will also need local currency loans for financing payroll and other administrative expenses. It is in this area that the local commercial banks may come into the productive sectors as financing partners of the international organizations. According to the commercial banks, however, the spreads offered on these loans are only 3% and therefore, fairly low. These spreads are considered as insufficient to cover the high cost of

64

administration of subloans. Nonetheless, these loans have been offset by the fact that the participating banks risk will be substantially or entirely covered by the government.

The commercial banks have also not been particularly successful in mobilizing savings. The total monetary mass was estimated to have reached GF 30 billion last year of which total deposits in the commercial banks amounted to GF 8.5 billion in end-July 1986 and could have possibly reached GF 15 to 20 billion by the end of 1986. The BICI-GUI alone claims to have deposits of GF 10 billion by October 1986. Thus, the ratio of deposits to money in circulation was 0.45 and reflected the lack of confidence of the public in the new banking system and the absence of bank branches in the rural areas of the economy. Throughout most of 1986, the banks have been fairly liquid which stems from the fact that although credit has expanded rapidly it is still modest in volume terms and banks have been able to finance most of their needs out of their own capital resources.

By the end of 1986 the banks' liquidity position did begin to tighten as the pool of start-up capital was depleted. The banks' demands for the opening of a refinancing facility at the BCRG has borne fruit with the commencement of such a facility at the beginning of 1987. Bank lending rates (rediscount rate plus 5%) have been established on the basis of BCRG's rediscount rates (normal rediscount rate: 15%, preferential rate: 10%). Refinancing facilities to the banks will include GF 200 to 300 million for ordinary loans and GF 500 million to finance this year's agricultural campaign. Some commercial banks have expressed concerns with BCRG's pre-occupation during 1986 for controlling the level of credit creation to within the limits set by the IMF rather than for the provision of additional liquidity to the banks. They stated that if certain international agencies were to make funds available for local productive development and put them under the control of the central bank, it is conceivable that the BCRG might in effect use the existence of these external funds to deny the banks access to additional refinancing. Furthermore, the fact that it has not set a policy on reserve requirements (an essential tool in this endeavor) can only be attributed to the general state of disorganization in the new institution. The Central Bank's credit department has already made recommendations to the board on reserve requirements (expected to be 5%) but policy in this regard has not been set forth to the public.

Macro Policies Affecting the Financial Sector

Given the recent implementation of the macroeconomic and sectoral reforms in Guinea, it is a bit premature to pass judgment on the effects of these changes on the financial sector or the ability of the sector to promote positive change in the economy. In a sense the creation of the commercial banks are an integral part of the reforms and thus indicate a positive step taken by the government to liberalize the financial sector. Nonetheless, the banks have contributed very little to the

65

development of other sectors because they perceive lending to most sectors in the economy as overly risky. Thus, before the commercial banks can play a serious role in channeling investment to the productive sectors and help achieve structural adjustment, several conditions have to materialize and policies must be established. These are the following:

Monetary policy: The three major initiatives taken by the government in this regard are:

(1) Credit policies: For all practical purposes the government did not have to intervene in the market during 1986 to control credit creation because the commercial banks were generally within the limits set by the IMF. Furthermore, most private sector credit creation took place from within the commercial banks own resources. Nonetheless, the banks are extremely reluctant to lend to the industrial and agricultural sector because of the lack of guarantees and rediscount facilities. Thus, a clear set of credit policies is required to boost a diversified investment climate.

(2) Inflation and pricing policies: The high inflation rate of 1986 was a major contributor to the commercial bank's reluctance to make medium- to long-term loans. The majority of commercial banking lending went into trade finance. Although the high inflation rate can be attributed to the one off price increase in basic commodities and the increased liquidity caused by the reimbursements of deposits from the state banks during mid year 1986, the private sector banks are uncertain about the ability or willingness of the government to exercise austerity measures over the medium term. They cite the slight resurgence of inflation in 1987 (25% to 35% during the first half) as an indication of this situation. The current interest rate ceiling of 17% has thus led to negative interest rates in the short run. The perception of continuing inflation has moved banks to charge large commissions and other intermediation fees. There are other reasons for the high commissions, such as the lack of collateral, but inflation has played a major role. This is particularly worrying to the government since the private sector may continue to operate outside the formal financial sector if these high intermediation costs continue.

(3) The government has implemented its exchange rate reform successfully using the banks as distributors of foreign exchange through a weekly auction. Nonetheless, the high commissions charged by the banks on these transactions can also be attributed to risk aversion.

Fiscal Policy: Government revenues were boosted during 1986 as a result of the tariff reforms and the devaluation. No substantial progress was made on reform the tax system although plans for this have been drawn up. Current expenditures were effectively contained despite an increase in civil servant salaries to compensate for the devaluation. With the liquidation of several parastatals the government was also able to reduce its

66

outlays to these institutions and decrease overall current expenditures. Capital expenditures have for the most part stayed fairly stagnant pending a total review of projects with the help of the World Bank. Given this improved fiscal situation, the government did not have to borrow from the private sector and its floating of development bonds was temporarily delayed.

Structural Adjustment Programs: The Guinean government has taken the first steps toward structural adjustment with the devaluation, banking sector reform, fiscal and administrative measures, and debt relief. These have gone far in stabilizing the economy and preparing it for the growth stage. Nonetheless, the government has not undertaken any policies to actively promote growth in the economy either through infrastructural investment or streamlining of business regulation despite the introduction of the investment code. In this environment the commercial banks have adopted a wait-and-see posture and pursued largely risk free lending. Their initial attempts at establishing provincial branches have been delayed due to the lack of proper service facilities (primarily telecommunications) and delays in licensing. To date only one branch has been opened outside Conakry. As was noted above, the government preoccupation with meeting the IMF credit targets has delayed its implementation of the rediscount facilities or reserve requirements which has also contributed to the banks' ambivalence to pursue productive investments despite three lines of credit made available by multilateral and bilateral lending agencies for this purpose.

The Guinean government's immediate objectives are to successfully implement the IMF and World Bank sponsored structural adjustment programs. If it does so then these agencies will release the second tranches of their loans and help Guinea fill the external financing gaps of 1987. Without these funds from the World Bank and the IMF, Guinea will have to negotiate with the Paris Club to reschedule its obligations in late 1987 and 1988. This outcome will no doubt represent a major setback for the government and have a negative effect on future foreign and domestic private sector confidence in the government's policies. If this materializes the prospects for externally funded productive investments in industry and agriculture are not particularly optimistic and could have an impact on the willingness of the commercial banks to expand their operations.

Both the IMF and the World Bank have a three-phased program. The first phase, mainly completed, includes eight items: a devaluation; increase in prices of main commodities; debt rescheduling; control of public expenditures through reduced transfers to public enterprises and reduced public sector employment; revamped public investment program; new investment code; and, the opening of new, privately managed commercial banks. With the exception of the public investment program the government has moved in all these areas. The next two phases which will be carried out during the late 1980s envisages

69

furthering the rehabilitation effort and growth through private sector employment.

A critical factor in the second phase will be the ability of the government to have control over its credit and monetary policy. Both the Bank and the Fund are worried about this; not so much in terms of the governments commitment but rather because of the political ramifications of public sector retrenchment. Although a large number of civil servants have been laid off, expenditure on salaries still needs to be cut. The will of the government to complete this reform, especially in light of weak prospects for reemployment elsewhere, is a factor that will greatly determine the release of the second tranches of the Bank and Fund loans. Furthermore, the commercial banks have been requesting rediscount facilities as their start-up capital pool dries up and private sector deposit mobilization has not picked up. While the government is still trying to establish such a facility it is also holding fast on credit creation and thus has to travel a fine line so as not to demoralize the banks.

3. CONCLUSIONS AND RECOMMENDATIONS

The Central Bank's ability to collect information about the financial sector is fairly limited due to its recent establishment. All data collected on the performance of the financial institutions are largely irrelevant for two reasons. First, most state banks and their clients, the parastatals, either do not exist anymore or have been totally restructured. Second, any information on the past does not give any insight into the private sector which either avoided doing business with the state banks or was excluded because of government regulations. On the other hand, the small size and concentration of the new formal financial sector has made monitoring the activities of the banks fairly easy and once the sector expands new information gathering methods can be systematically developed. Accelerating this process through the use of modern technologies and methods of analysis would be highly desirable.

Thus, the lack of data on the Guinean financial sector is not entirely a function of bad record keeping or disorganized institutions. It is rather a result of the newness of the sector itself. Similarly, the macroeconomic reforms are only a year old and for the most part have been successfully implemented. Within this context the financial sector has done well in supporting the reform although some problems are cropping up. The implementation of other structural adjustment policies (mainly administrative and procedural) and infrastructural investment programs will give the financial sector incentive and opportunities to expand its influence and overcome the problems created after the first phase of the reforms.

Given this overall macroeconomic situation and the state of the financial sector, it is recommended that policies be promoted which help prepare the central bank to support the financial sec-

tor. The major reforms have generally been taken by the government. Assistance could be extended in the following areas:

--Encouraging the government to develop a comprehensive credit policy keeping in mind the need to keep within the guidelines of the IMF program in the short run. In the long run, AID should provide technical assistance to the central bank to promote growth strategies by encouraging the banks to become full service financial institutions.

--Helping to develop specific mechanisms such as refinancing windows at the BCRG to make available term investment credit to small industry and agriculture.

--Providing technical assistance to the BCRG for developing information systems, market data, and statistical information on the banking sector.

69

BIBLIOGRAPHY

Deschamps, J (1986), "Review of Guinee Financial Markets and of USAID/Conakry's Credit Strategy", Manuscript (Washington, D.C.: 1986).

IBRD (1986), "National Recovery Program Medium-Term Development Prospects, 1987-1991", Manuscript (Washington, D.C.: 1987).

IBRD (1986), "Report and Recommendations of the President of the International Development...", Manuscript (Washington, D.C.: 1986).

AID, "Country Development Strategy Statement", AID (Washington: 1987).

IBRD, "Report and Recommendations on a Proposed Development Credit to the Republic of Guinee", Manuscript (Washington, D.C.:1985).

IBRD, "Report and Recommendations on a Proposed Credit to the Republic of Guinee", Manuscript (Washington, D.C.:1986).

La Republique de Guinee, "Code des Investissements et ses Application" Conakry, Guinee: 1987.

Michelini, P., "Guinee's new Policy Direction Provides Business Opportunities", business article (Washington, D.C.:1987).

Kemoko, Keito, "Industrial Structural Adjustment Program", Manuscript (Conakry, Guinee:1987).

Editions Fid., "Memento Guinee" (Paris: 1986).

Center for Strategic Studies, "Guinee's Economic Potential and Prospects", Manuscript (Washington, D.C.: 1987).

Equator Advi., "Investment Climate Assessment - Republic of Guinee", Manuscript (Hartford, CT: 1986).

AID, "Guinee Private Agribusiness Preparation Project", Manuscript (Washington, D.C.: 1987).

THE WEFA GROUP

GUINEA

OCT 13, 1987

MACROECONOMIC VARIABLES

	80	81	82	83	84	85	86
GROSS NATIONAL PRODUCT, MILL US$	1632.0	1608.5	1569.9	1757.2	1841.2	1841.7	NA
GNP PER CAPITA, US$	NA	NA	NA	NA	NA	NA	NA
EXPORTS, FOB, MILL US$	496.0	493.0	444.0	503.0	532.0	493.0	27.1
CURRENT ACCT. BAL., MILL US$	19.0	-64.0	-34.0	1.0	-27.0	NA	NA
TOTAL EXTERNAL DEBT, MILL US$	1031.7	1260.9	1244.3	1248.9	1170.4	1292.3	NA
CONSUMER INFLATION, 1980=100	NA	NA	NA	NA	NA	NA	NA
US$/SYLIS, PERIOD AVERAGE	0.05	0.05	0.04	0.04	0.04	0.03	0.03
POPULATION, MILL.	NA	NA	NA	5.8	NA	NA	NA

MONETARY SURVEY

	80	81	82	83	84	85	86
MONEY SUPPLY, M2, BILL. SYLIS	NA	NA	NA	NA	NA	NA	NA
CONSUMER INFLATION, 1981=100	NA	100.0	104.4	116.4	NA	NA	NA
WHOLESALE PRICE INDEX,1980=100	NA	NA	NA	NA	NA	NA	NA
DISCOUNT RATE	NA	NA	NA	NA	NA	NA	NA
COMMERCIAL PRIME RATE	NA	NA	NA	NA	NA	NA	NA
GOVT. BOND YIELD, MEDIUM TERM	NA	NA	NA	NA	NA	NA	NA
DEGREE OF MONETIZATION	NA	NA	NA	NA	NA	NA	NA

GUINEA

CONSOLIDATED BALANCE SHEET OF
COMMERCIAL BANKS
BILLION SYLIS

	80	81	82	83	84	85	86
ASSETS							
RESERVES	NA	NA	NA	NA	NA	NA	NA
FOREIGN ASSETS	NA	NA	NA	NA	NA	NA	NA
CLAIMS ON GOVT.	NA	NA	NA	NA	NA	NA	NA
CLAIMS ON PRIVATE SECTOR	NA	NA	NA	NA	NA	NA	NA
LIABILITIES							
DEMAND DEPOSITS	NA	NA	NA	NA	NA	NA	NA
TIME AND SAVINGS DEPOSITS	NA	NA	NA	NA	NA	NA	NA
FOREIGN LIABILITIES	NA	NA	NA	NA	NA	NA	NA
GOVT. DEPOSITS	NA	NA	NA	NA	NA	NA	NA
CREDIT FROM CENTRAL BANK	NA	NA	NA	NA	NA	NA	NA
CAPITAL ACCOUNTS	NA	NA	NA	NA	NA	NA	NA
VALUATION ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
OTHER ITEMS, NET	NA	NA	NA	NA	NA	NA	NA

BALANCE SHEET OF CENTRAL BANK

	80	81	82	83	84	85	86
ASSETS							
FOREIGN ASSETS	NA	NA	NA	NA	NA	NA	NA
CLAIMS ON GOVT.	NA	NA	NA	NA	NA	NA	NA
CLAIMS ON OFFICIAL ENTITIES	NA	NA	NA	NA	NA	NA	NA
CLAIMS ON COMM. BANKS	NA	NA	NA	NA	NA	NA	NA
CLAIMS ON SPECIAL BANKS	NA	NA	NA	NA	NA	NA	NA
LIABILITIES							
RESERVE MONEY	NA	NA	NA	NA	NA	NA	NA
OF WHICH							
CURRENCY OUTSIDE BANKS	NA	NA	NA	NA	NA	NA	NA
QUASI-MONEY DEPOSITS	NA	NA	NA	NA	NA	NA	NA
FOREIGN LIABILITIES	NA	NA	NA	NA	NA	NA	NA
CAPITAL ACCOUNTS	NA	NA	NA	NA	NA	NA	NA
RESCHEDULING ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
VALUATION ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
OTHER ITEMS, NET	NA	NA	NA	NA	NA	NA	NA

72

GUINEA

GOVERNMENT FINANCE
BILLION SYLIS

	80	81	82	83	84	85	86
DEFICIT(-)/SURPLUS(+)	NA	4.5	6.3	2.4	0.8	NA	NA
REVENUE	NA	11.5	15.4	10.2	10.7	NA	NA
EXPENDITURE	NA	7.0	9.1	7.8	9.9	NA	NA
FINANCING							
DOMESTIC	NA	NA	NA	NA	NA	NA	NA
FOREIGN	NA	NA	NA	NA	NA	NA	NA

INTERNATIONAL DEBT
MILL. US$

	80	81	82	83	84	85	86
TOTAL EXTERNAL DEBT, (EDT)							
LONG-TERM DEBT	1031.7	1260.9	1244.3	1248.9	1170.4	1292.3	NA
PUBLIC AND PUBLICALLY GUARANTEED	1031.7	1260.9	1244.3	1248.9	1170.4	1292.3	NA
PRIVATE NONGUARANTEED	0.0	0.0	0.0	0.0	0.0	0.0	NA
USE OF IMF CREDIT	5.2	0.3	12.7	12.0	11.3	12.6	NA
SHORT-TERM	51.0	61.0	58.0	58.0	54.0	76.0	NA
TOTAL LONG-TERM DEBT							
DEBT OUTSTANDING AND DISBURSED	1031.7	1260.9	1244.3	1248.9	1170.4	1292.3	NA
DISBURSEMENTS	119.3	141.5	86.8	97.9	85.3	97.3	NA
PRINCIPAL REPAYMENTS	72.4	60.6	53.2	45.9	93.8	46.0	NA
NET FLOWS	46.9	80.9	33.6	52.0	-8.5	51.3	NA
INTEREST PAYMENTS	22.9	21.7	24.2	21.3	21.9	19.6	NA
NET TRANSFERS	24.0	59.2	9.4	30.7	-30.4	31.7	NA
TOTAL DEBT SERVICE	95.3	82.3	77.4	67.2	115.7	65.6	NA
PRINCIPAL RATIOS							
TOTAL EXTERNAL DEBT							
EDT/XGS)	NA	NA	NA	NA	NA	NA	NA
EDT/GNP	66.7	82.2	83.8	75.1	67.1	75.0	NA
INTERNATIONAL RESERVES	NA	NA	NA	NA	NA	NA	NA

B. KENYA

1. MACROECONOMIC SURVEY

a. Background

Economic performance was good during the first decade of independence, with an average growth rate of 6.6% for GDP over the period 1963 to 1973. The development strategy was "mixed" with widespread government participation. Development of the industrial sector used import-substitution policies dependent on imported intermediate inputs. There was, and still is, considerable segmentation between the protected formal and the informal sectors. The economic structure, while more diverse than some in Sub-Saharan Africa, is still very dependent on the agricultural sector. Agriculture accounts for about one-third and industry about 20% of GDP. Much of the activity in the manufacturing sector is processing agricultural inputs. Over 80% of the population is in rural areas and primarily reliant on income from agriculture.

The export position is also dependent on agriculture, especially tea and coffee exports. This has contributed to the boom and bust pattern in the trade accounts. Growth slowed after 1973 except for brief commodity booms. The Kenyan economy prospered in 1977-78 when the Brazilian coffee crop failed and world coffee prices skyrocketed. The economy again benefitted from high tea prices in 1983-84. However the boom was cut short by the 1984 drought which cut Kenyan tea production. The economy has done fairly well with high coffee prices in 1986-87. However, these boom periods have been separated by periods of slow or moderate growth and severe foreign exchange shortages.

b. Economic Performance in the 1980s

Economic growth slowed in the early 1980s with large budgetary deficits and shortage of foreign exchange. Kenya accumulated record current account deficits, over 11% of GDP, in 1980-81. These deficits were financed by heavy borrowing and a reduction in the level of foreign reserves. Borrowing shifted somewhat from commercial to concessional terms. The response to the adverse balance of payment situation was to restrict domestic demand in 1982 and 1983 by lowering the government budget deficit, decelerating monetary growth, raising nominal interest rates to positive real terms, permitting real wages to fall, and restricting imports. Drastic adjustment kept the growth rate positive, but very low. Growth rates in GDP at factor cost, in constant 1982 prices, were 4.0% in 1980, 6.0% in 1981, 1.8% in 1982, 3.5% in 1983, and only 0.9% in 1984 with the drought.

The government budget deficit was kept under control with demand management policies by cutting government expenditure from 35% of GDP in FY 1981 to 28% of GDP in FY 1985. The government deficit was cut from 9% of GDP in FY 1981 to just over 4% of GDP

74

in FY 1985. The current account deficit was small in 1983 and 1984. However, external debt had more than trebled between 1980 and 1984 and the debt servicing ratio rose from 13% in 1980 to 29% in 1984. The situation improved somewhat in 1985 with the return of the rains and lower oil prices, and in 1986 with higher coffee prices and a boost in tourism. Although real GDP growth was estimated at 5% for 1986, the budget deficit increased to 6.3%.

c. Unresolved Macroeconomic Issues

Kenya did better than many countries in short-term adjustment to the external shocks of the early 1980s and the drought. Kenya implemented demand management policies, which coupled with higher coffee and tea prices, kept the budget and trade deficit under control, even though both deficits are probably above sustainable levels. There has been little effort to implement policies that would reduce the budget deficits in the long run, such as divesting unprofitable parastatals.

Kenya has been in a position to take advantage of the occasional jumps in tea and coffee prices in the last decade because the economy does allow some flexibility to respond to market forces. However, the periods of growth have not been used to undertake needed economic reforms. The Kenyan economy remains segmented with import substitution protection intact for the modern sector, but the majority of the population engaged in smallholder agriculture and informal sector activities. The Kenyan economy is not sufficiently diversified to avoid the boom and bust pattern of growth seen since the 1970s.

While Kenya has maintained a reasonable exchange rate policy, there has been little progress in either capital account or current account liberalization. Kenya announced intentions to liberalize trade as early as 1980, but the policy was stalled by recurrent foreign exchange shortages such as the one in 1982. Interest in trade liberalization was revived in 1985, but little substantive progress has been made even though foreign exchange has not been tight. Even though the number of items on the free list of imports was increased in the June 1985 Budget Speech, the import substitution structure is still in place and reflected in domestic relative prices. Until the current account is liberalized, the distortions between financial and economic returns give incorrect signals for long-term investment.

2. FINANCIAL SECTOR

a. Introduction

By the early 1980s Kenya was reasonably deep in financial assets. At the end of 1983 financial assets, defined as the sum of broad money and total securities, was 64% of GNP. This compares well with 62% for Nigeria which had a per capita income of US $870 in 1983, twice that of Kenya and is higher than the

75

27% ratio for Indonesia, a country which also had a higher per capita income.

It is noted that throughout this chapter, the term financial institutions covers both commercial banks and NBFIs. The term NBFI includes building societies. By June 1986, the financial sector included the Central Bank, 24 commercial banks with 419 branches, 50 nonbank financial institutions with 89 branches, 10 development financial institutions, a Post Office Savings Bank, over 900 cooperative savings and credit societies, and 52 insurance companies.

The rapid growth of NBFIs, both in market share and in the number of institutions, has been one of the most notable characteristics of the financial sector during the 1980s. There were 9 new banks and 31 new NBFIs licensed between 1980 and 1985. The rapid increase in the number of financial institutions in Kenya can give the impression of a very dynamic sector. However it would be a mistake to assume that there is much innovation. Lending practices are still conservative and are mostly for short-term trade credit. Although the availability and the range of services has increased, many of the newer financial institutions that were supposed to introduce innovation have been unstable and there have been 6 financial institution failures.

Development of money and capital markets has lagged behind the banking sector. There is no bond market, no secondary market for Treasury Bills, and little Central Bank rediscounting. The stock market is small, with only a few traders and a few stocks. There are no full-service security firms operating in Kenya to provide the brokerage and dealership functions for short-term instruments or underwriting facilities for long-term securities.

b. Commercial Banks

Of the 24 commercial banks in Kenya, two are under receivership. Starting from a base of 11 banks in 1970, 4 multinational banks entered during the 1970s, 2 more multinationals entered in 1981 and 1982, a privately owned Kenyan bank started in 1982 and additional banks entered batween 1983 and 1985. In other words, the number of licensed banks more than doubled between 1970 and 1985, with a total of 240 full-service branches and 160 sub-branches. In addition, 2 new banks have entered since 1985.

Three banks dominate the banking sector: the government-owned Kenya Commercial Bank (formerly Grindlays Bank) and two multinational banks, Standard Bank and Barclays Bank. The market share of these 3 banks has declined slowly, but they still have over half the private-sector loans and more than 60% of deposits. In mid-1983, they owned all but two of the branches outside of Nairobi and Mombasa, although this situation is changing.

16

There is government distrust of the major banks, particularly the multinationals, and suspicion of collusion because there is little visible competition within the financial sector. The extent to which larger commercial banks have or exploit market power cannot be investigated because the only available price data are the official interest rate schedules, which are a poor representation of pricing reality. In many sparsely populated areas of the country, there is potential for banks to act as spatial monopolists and potential for bank managers and loan officers to extract the economic rent from regulated lending rates. However, the declining market share of the major banks and Central Bank control of the clearing house make explicit cartel policies doubtful. It is true, however, that competition among financial institutions has been limited, even in Nairobi. With the exception of a few new NBFIs, competition to offer new products or services was notably lacking. The range of financial instruments and services available in the Kenyan financial markets was, and still is, quite limited.

The newer financial institutions were slow to challenge the older banks for the business of the general public. One of the few manifestations of competition was branching in Nairobi. A few blocks in the heart of the city seem to be dominated by financial institutions. Besides opening new branches in densely populated areas, there were few visible signs of competition for deposits before 1982-83. During the period of intense competition in 1983-85, the NBFI concentrated on larger term deposits rather than on small deposits. There has been little effort to improve retail banking services. Transaction costs for consumers are high. Cashing a check, withdrawing funds, or other simple transactions are time-consuming since banking records are checked manually. Computers and other information-processing technologies are conspicuously absent even in bank head offices. Besides low profitability on high volume retail transactions, some banks argue that they do not improve retail services because the general public, especially outside Nairobi, is only interested in a few services and instruments.

The deposit base in commercial banks is growing slowly. The ratio of bank deposits to GDP was almost constant for the period 1980 to 1984: 26.0% in 1980; 25.9% in 1981; 27.2% in 1982; 25.1% in 1983; and 25.8% in 1984. Between one-third and one-half of the aggregate commercial bank deposit base is in demand deposits. There has been a slight increase in the percent of the commercial bank deposit base held in time and savings deposits because of the increased competition from NBFI. This has also increased the average costs of funds. However, it is still basically a short-term deposit structure which makes term financing risky.

Commercial bank lending is overwhelmingly short term, i.e. three years or less or in overdraft facilities. The banks, typically, only do asset-backed lending. The market value of the collateral must exceed the value of a loan by a considerable margin, frequently as much as 150%. The vast majority of loan funds goes to large prime domestic borrowers and multinationals.

77

The largest share of private-sector commercial bank credit goes to the trade sector with over one-fourth of total lending. The manufacturing sector share has been 20% to 25% and the agricultural share between 13% and 17%.

As of the end of 1986, the major banks were liquid and had fairly low loan-to-deposit ratios:

Ratio of Total Bank Advances to Total Deposits

Year	Ratio
1980	87.3
1981	84.1
1982	79.6
1983	83.5
1984	82.1
1985	85.0
1986*	82.4

Note: * First six months only.

The GoK has sponsored two unsecured small loan schemes through the Kenya Commercial Bank with funds from donor agencies. The first, Gua-Kali, made available KSh 2.5 million to the informal sector at 14% interest with the bank paying 8% to USAID for funds. There is a complete credit guarantee for the KCB with a KSh 2.5 million fund set aside to cover default, administrative costs, etc. The second scheme, for KSh 20 million, is for small-scale enterprises in the manufacturing sector, and was also financed with donor funds. The credit is available for working, not fixed, capital. The GoK has given KCB a 75% guarantee on these loans.

During several periods in the 1980s, the government has called upon the commercial financial institutions for financing. Public sector borrowing from the commercial banks was 2.9% in 1980, 2.6% in 1981, 3.8% in 1982, 7.1% in 1983, 8.5% in 1984, 8.4% in 1985, and 7.8% by mid-1986. These statistics on commercial bank lending to the government significantly understate exposure, however, since much lending to parastatals is listed as private-sector lending.

Allocation of Nominal Bank Credit (Mln K pounds, 1 pound = 20 KSh)

	1980	1981	1982	1983	1984	1985
Government	349	342	560	1,154	1,514	1,753
Priv. Enterprise	11,149	11,935	13,374	14,255	15,924	18,222
Private Household	727	916	698	825	728	924
Total	12,225	13,193	14,632	16,234	18,196	20,899

The Cooperative Bank is included in the statistical base of commercial banks but operates with a different mandate. The Cooperative Bank provides banking facilities for member productive and savings cooperatives. The Cooperative Bank on-lends World Bank and other donor funds and has passed through a significant amount of credit to the agricultural sector. In addition to short-term lending to the agricultural sector, and lending to support activities of cooperatives in other sectors, the Cooperative Bank has also done limited equity investing in commercial real estate, timber mills, and agro-industry. The subsidiary of the Cooperative Bank, the Cooperative Finance Company, finances term lending and mortgage facilities for nonagricultural investments.

c. Nonbank Financial Institutions

There are currently about 41 NBFIs operating with about 50 branches. NBFIs have grown in number and importance during the 1980s. In 1970 there were only eight NBFIs, and 24 by the end of 1980. Before 1980, most were subsidiaries of commercial banks. Many of the NBFIs started since 1980 have been independent institutions, and now about half of the NBFI are not affiliated with commercial banks. The NBFI sector is less concentrated than the commercial bank sector. There are several large institutions, but they do not dominate the market the way the three largest banks dominate banking.

The growth of the NBFIs is one of the most important trends in the Kenya financial sector. Between 1967 and 1985 the average annual growth rate for deposits was 16.0% in the banking system and 25.8% in NBFI. Of total bank and NBFI deposits, the nonbanks held 18% in 1970, 26% in 1980, 35% in 1984, and 37% by mid-1986. Between 1980 and mid-1986 total deposits of NBFI increased over three times, from KSh 4.9 billion to KSh 16.0 billion. Over the same period, bank deposits only doubled, from KSh 14.0 billion to KSh 27.4 billion. The NBFI share of total lending rose from 15.1% in 1967 to 36.7% in 1985. At the end of 1985 total NBFI assets stood at KSh 19.9 billion, compared to KSh 30.0 billion for banks.

79

Central Bank regulation of NBFIs (see below) has been less restrictive than for commercial banks. To compensate for a more expensive deposit base, the lending ceiling for NBFIs is 18% compared to 14% for commercial banks. The NBFIs, with the interest rate differential, attracted a lot of short-term deposits from banks and parastatals. Because there is not a money market, there is very little competition except the NBFIs and the smaller aggressive banks for short-term deposits.

The NBFIs engage in lease hire, hire purchase, merchant banking, and housing finance. The smaller NBFIs tend to be specialized, usually in hire-purchase activities. Only a few, usually the larger, NBFIs do diversified or flexible lending. The larger institutions, e.g. Kenya Commercial Finance and Diamond Trust, offer a full range of services encompassing consumer finance, hire-purchase, mortgages, discounting bills of exchange, term loans and other services such as underwriting. (Diamond Trust underwrote the stock issue for Jubilee Insurance.) In recent years some NBFIs have entered new activities, such as bills discounting, bridging finance, and term loans. Many NBFIs claim to be moving away from strictly asset-based lending to project finance based on projected cash flows. However, the amount of credit that actually goes for project finance is still small.

Housing finance dominated NBFIs lending with over one-fourth of the total, followed by lending to other business enterprises. Lending to trade, manufacturing, and construction is also important. The NBFIs are asked to lend 10% of the deposit base to agriculture, but aggregate lending is below this level. NBFIs have only recently started opening offices outside Nairobi and Mombasa. However, many of the Nairobi-based NBFIs have some rural lending to industrial ventures in the rural regional centers, to large-scale agriculture, or for agricultural equipment.

d. Savings Mobilization and Credit Demand

The savings instruments used by banks and NBFIs are not designed to mobilize funds from small savers. Most financial institutions allow clients to start savings accounts with an initial deposit of as little as KSh 100 but money cannot be withdrawn until the account reaches the required minimum balance. The minimum requirement varies by bank but is usually about KSh 500 and much higher for several NBFIs. The institutions also specify the minimum size and frequency of allowable transactions. In addition transaction costs are very high in rural areas. Only the largest banks use mobile units.

It is difficult to characterize the demand for credit because of self-selection in credit applications and credit rationing. The economy is still strongly segmented between and among sectors. Multinationals and the Asian community play a strong role in the formal segment of many sectors. The informal segment will usually be rationed out of the formal credit markets because

80

of the nature of the activities and the lack of collateral. The credit demand from the informal sector is not expressed in a way that can be monitored.

It is also difficult to characterize credit demand in agriculture. Bankers frequently report that the effective demand for rural credit is low. This generalization seems questionable, and when it is true, may result from imperfect and incomplete rural markets. Most rural residents in the major agricultural areas are familiar with credit use. When the British left, land in many parts of the country was sold to Kenyans on credit. While repayment on those long-term land purchase loans has been poor, the process of debt financing with interest payments and potential loss of collateral with default was used throughout the major agricultural areas. While limited demand might be true in some areas and under certain types of production systems, the observation is not generalizable. Even in rural areas, the demand is probably much greater than expressed. The heart of the effective demand problem is lack of viable projects for investment opportunities.

e. Regulation of the Commercial Banks and NBFI

The commercial banks and the nonbank financial institutions (NBFI) are regulated by the Central Bank under the Central Bank of Kenya Act and the Banking Act. There is a problem of coordinating the regulatory responsibilities of the Ministry of Finance and the Central Bank. The Ministry of Finance licenses new financial institutions, and this has been done until recently without close consultation with the Central Bank, although the Central Bank has been consulted more closely since the 1985 Amendments to the Banking Act.

The financial institutions have been differentiated since the Banking Act of 1968, with commercial banks offering a broader range of services than NBFIs. (NBFIs are prohibited from offering checking accounts and engaging in foreign exchange transactions.) Commercial financial institutions are subject to interest rate guidelines, liquidity requirements, credit ceilings, and selective credit controls. These regulations are detailed in the appendix. The Central Bank sets maximum lending rates and minimum deposit rates for the commercial financial institutions.

The official lending rate was below or near the inflation rate before 1983, and real rates have been positive since 1983. The maximum lending rate on commercial bank loans is 14%, the maximum for NBFIs was recently lowered from 19% to 18%, and the minimum deposit rate for both is 11%. Inflation was about 6% in 1986, so real lending rates have been fairly high. The Central Bank imposes reserve requirements of 20% on banks and 24% on NBFIs. The Central Bank has occasionally imposed ceilings on the growth of bank credit for monetary restraint. Both the commercial banks and NBFIs are encouraged to meet lending targets to agriculture. The 1985 Amendments to the Banking Act raised

the capital standards, but the higher standards are not due to go into effect for several years.

Historically the Central Bank has relied on "moral suasion" to guide the performance of the commercial financial institutions. There were long lags between examinations. The weaknesses in the Central Bank examination and supervision department became apparent with recent financial institution failures.

Until recently the regulations for NBFIs have been less restrictive than for commercial banks. However, there has been an attempt in the last few years to change regulations to slow the largely unrestrained growth of NBFIs. This was done in mid-1983 by raising the reserve requirement for NBFIs and imposing more restrictions on interest rates. Those reforms were partially a result of the need to cover the government budget deficit and partially in response to specific abuses by the NBFIs. Although the 1985 Amendments to the Banking Act also strengthened the regulation of NBFIs, there are still considerable regulatory differences and need for further "leveling of the playing field".

On the surface, the Kenyan financial system seems to fit the description of a "repressed" system. The Central Bank sets lending guidelines, reserve requirements, and agricultural lending targets for banks and nonbank financial institutions. Interest rate controls, especially the negative real lending rate imposed in the past, restricted the profitability of intermediation. However, regulations may not be a major problem for growth of the system. The regulations on the Kenyan financial system have never been strictly enforced and are frequently ignored by the financial institutions. Inspections have been very rare and reporting requirements lax. Most Kenyan financial institutions have unofficially maintained lending rates above the official lending guidelines and used a combination of commitment fees and compensating balances, both of which are illegal. Some NBFIs have used a variety of fees and a flat interest rate schedule, both of which were outlawed for NBFIs in 1983, to obtain very high real lending rates. Similar gaps between the regulations and standard operating practices can be found for many other activities. This includes the reserve requirement, foreign exchange transactions, capital adequacy standards, certifying collateral, and accounting standards. The regulations may not have constrained the growth of the financial sector as much as it provided the incentives for more rapid growth of NBFIs with less restrictive regulations and less stringent enforcement.

f. Stability of the Financial Sector

The stability of the financial institutions in Kenya is in question. Many of the new NBFIs are poorly capitalized and have poor quality portfolios. These institutions can remain open only as long as the Central Bank does not strictly enforce the banking

82

laws. The problem may get worse because recent regulatory changes are expected to reduce the profitability of NBFIs.

The financial markets of Kenya were shaken by a rash of failures in mid-1986. The first NBFI to fail was Rural and Urban, followed by the Pioneer Building Society and the Continental and Jimba financial groups in August and September of 1986. A total of two banks, four NBFIs, and one security company failed. These included the largest indigenous bank, the Continental Bank of Kenya, and the parent finance company, Continental Credit Finance Limited.

While some details are not public yet, it is clear that the failures were primarily due to unsound or illegal banking practices. All of the institutions that failed were part of complex interlocking companies e.g. the Continental group of Continental Credit Finance Ltd. and Continental Bank of Kenya Ltd., and the Jimba group with Jimba Credit Corporation and the Union Bank of Kenya Ltd. The banks had been redepositing funds in the NBFI for term lending at the higher rate which exposed the banks to liquidity shortages. This was especially dangerous since the institutions were poorly capitalized. The failures also revealed unsecured insider loans to directors and managers, and the institutions were keeping inaccurate accounts. All of the failures showed a general pattern of weak business management and unmet capital requirements that went unchecked by the Central Bank regulators. There was the additional problem of coordinating responsibility between the Attorney General and the Central Bank.

Deteriorating conditions in some of the NBFIs and the obvious potential for widespread instability prompted a government response in the form of the 1985 Amendments to the Banking Act. Licensing of new banks and NBFIs is to be channeled through the Central Bank before being approved by the Minister of Finance. Representative offices of foreign banks were brought under the control and supervision of the Minister of Finance. For locally incorporated institutions, the minimum capital was raised to KSh 15 million for a bank and KSh 7.5 million for as NBFI. For financial institutions incorporated outside Kenya, the capital required for a bank was raised to K. shs. 150 million and K. shs. 75 million for an NBFI. The ratio of required capital to deposits was raised from 5% to 7.5% of deposits. The amendments provided for a reserve fund built up from net profits over time, to stop the practices of paying dividends before making provisions for bad and doubtful debts, and of building reserves toward capital standards. Monies for the reserve fund must be held in government or other authorized securities.

Section 10 prohibits banks and NBFIs from granting unsecured advances and credit facilities of more than KSh 10,000 to directors or their relatives, and employees or their relatives. Section 11 prohibits bank or NBFI investment in immovable property or lending against security of immovable property, and restricts trading activities. NBFIs, with only a few exceptions,

83

were barred from acquiring or holding any part of share capital or direct interest in a financial, commercial, industrial, or other undertaking where the value of the financial institution interest would exceed 25% of the sum of its paid-up capital and unimpaired reserves. Section 11B prohibited NBFIs from owning equity in banks. While this regulatory change was meant to keep NBFIs from using banks as a cheap source of funds, the regulation was easily circumvented. It was possible to switch so that the bank owned equity in the NBFI. The regulation did not significantly reduce the risk of interlocking management or insider lending within company groups.

These banking amendments also created a deposit protection fund which began operating on September 1, 1986. The fund insures all depositors up to KSh 100,000. Larger depositors have a general claim on the remaining assets in the event of financial institution failures. Banks and NBFIs are required to contribute 0.1%, of deposits as an insurance premium, never to exceed 0.4% of the total deposit liabilities. Section 22 c(6) allows for a higher assessment rate if an institution is believed to be excessively risky. This provision is essential, in that deposit insurance schemes that do not assess premiums on the basis of risk encourage financial institutions to take on even more risk. In financial markets with accurate financial information, it is usually assumed that larger depositors will exert some market discipline on risky institutions by switching deposits to the safer institutions. There has been some market discipline after the early failures. However, this form of discipline is weakened to the extent that (a) insurance allows depositors to diversify deposits under KSh 100,000 among several risky institutions, and (b) the public does not have enough information to judge the riskiness of the financial institutions.

The GoK has established a Presidential Special Investigation Committee (SIC) to study the problems of financial market instability. There is ambiguity in the official treatment of the unsafe financial institutions. The newer financial institutions were to be more innovative in lending to the traditional sectors of the economy and reduce the dependence on multinational financial institutions. However, enforcing the capital requirements and strict monitoring of banking regulations would close many of the new indigenously owned Kenyan financial institutions. The desire to assist innovative financial institutions must be weighed against the possible chance of market failures and insolvency of the deposit insurance scheme if the undercapitalized institutions fail. It is estimated that up to 10 NBFIs (30% of the total) remain in a very weak financial position, and should be closed. There are also several banks in very questionable financial positions. It appears that the current government strategy is to avoid panic in the financial markets by restructuring and then reopening the worst institutions -- evidenced by the recent reopening of Jimba.

84

g. Reform of the Financial Sector

The recent crisis has raised some fundamental issues of financial market development strategy and regulation. The banking amendments of 1985 did not resolve several of the problems that allowed the instability to grow unchecked in the sector in the early 1980s. In the short run the GoK needs to deal with stability of the financial sector. The supervisory powers of the Central Bank need to be strengthened. The number of bank inspectors has been increased from 4 to 20, but even this number may not be adequate. The threat of closing high-risk financial institutions needs to be credible. Some of the undercapitalized institutions that are continuing to engage in high-risk lending must be closed and restructured to avoid the impending drain on the newly established deposit insurance scheme. The moral hazard problems of the flat-rate deposit insurance scheme should be corrected as soon as possible to reduce the incentive for financial institutions to take on more risk. Options for accomplishing this include moving to a more limited risk-sharing deposit insurance, or increasing the risk premiums on risky institutions. Finally, the pattern of interlocking ownership and management and insider loans between NBFIs and banks and between financial and commercial ventures needs to be regulated more effectively than was done in the 1985 Amendments. These policies would be easier to implement if the power to supervise, penalize, and close were centralized in the Central Bank. The Central Bank should also play a larger role, if not the major role, in the initial licensing of financial institutions to insure compliance with the capital requirements and rationalize the sector's growth strategy.

The NBFIs are a creation of regulatory and enforcement disparities. In the longer run the GoK may want to consider the option pursued by several other countries of reducing regulatory disparities among types of financial institutions and eventually removing the distinction between NBFIs and banks. This would strengthen and diversify lending practices, and encourage weaker NBFIs to be taken over or merged with stronger institutions.

The record on small-scale lending through the commercial banks is dismal, largely reflecting the bias in government policy favoring large-scale import-substitution ventures. Small-scale lending is primarily through overdraft facilities, payable on demand which is a risky way to fund either medium or long-term investments. Some outside donors are considering credit guarantee schemes through commercial banks. Unfortunately this creates a host of new problems, such as highly leveraged companies, adverse selection, and moral hazard. These schemes should be undertaken in conjunction with trade liberalization, i.e. a change in domestic relative prices. It will be necessary to change relative prices to give banks the incentive to change the allocation of credit. Credit guarantees are more effective as finite tools to ease the transition to lending to new sectors, rather than as an incentive to counterbalance unfavorable relative prices.

Opportunities should be pursued to allow financial institutions to diversify both the asset and liability side of the balance sheet. The financial institutions in Kenya need to increase the range of liabilities, such as (a) certificates of deposit, (b) term repurchase agreements to allow financial institutions to swap T-Bills and securities for cash with pension funds and other institutional investors, or (c) interest bearing checking accounts, such as offered by Citibank, or some other form of instrument that would pay interest while providing liquidity. Many financial institutions need to increase their capital base, perhaps by issuing debt or equity instruments.

The immediate problem of restoring stability in the financial sector will not be easy, since there are several NBFIs that need to be closed. However, the larger institutions are generally in fair to good economic condition. This leaves Kenya with the opportunity of encouraging the larger institutions to offer new services and instruments, once the instability problem is resolved. However, the government has turned down several proposals for new products by banks, such as discount facilities for export credit. Central Bank rigidity on new practices and products may become more of a problem after it has attempted to stabilize and restructure the shaky NBFIs.

3. COMPLEMENTARY FINANCIAL INSTITUTIONS AND SYSTEMS

a. Development Banks and Parastatal Lending Institutions

There are five major development banks: the Industrial Development Bank Ltd. (IDB), the Development Finance Company of Kenya (DFCK), Kenya Industrial Estates Ltd. (KIE), the Industrial and Commercial Development Corporation (ICDC), and a smaller development bank, the East African Development Bank (EADB). The development banks have been the primary source of term funds for industry, and also make some equity investments. These institutions on-lend foreign aid funds as well as GoK funds.

The total loan and equity portfolios of these development finance institutions as of December 1983 was KSh 2.4 billion, which was only 10% of the total private-sector loans of commercial banks and NBFIs. Several of the development banks had very little new activity in the mid-1980s, partially because of slack demand for foreign currency loans and partially because of ongoing portfolio quality problems. In general there is a great deal of duplication in the operations of the development banks, and the World Bank has pushed for mergers and consolidation.

There are six specialized public sector lending institutions: the Agricultural Finance Corporation (AFC), the Agricultural Development Corporation (ADC), the National Housing Corporation, the Housing Finance Company of Kenya, the National Construction Corporation, and the Kenya Tourist Development Corporation. No attempt will be made to analyze the operations of the development banks or the parastatal lending organizations in detail. However

86

a few generalizations can be offered: (a) these institutions do not take deposits and are dependent on GoK or foreign aid funds; (b) they are undiversified and concentrate in only one sector; (c) they are expected to provide management guidance as well as credit; and (d) they do term lending and some limited equity investing. The institutions that have done equity investing have been very slow to divest. Successful firms are kept to cover the losses in the portfolio. The institutions have poor repayment rates and severe asset quality problems in the portfolios. Activities of these institutions were restricted under difficult economic conditions of the early 1980s and budgetary allocations to some of these institutions have fallen. Lending was strong in 1982, fell off in 1983-84, increased somewhat in 1985, and was constrained by foreign exchange risk in 1985-86. Lending rates are now comparable to commercial banks and the final borrower must assume foreign exchange risk.

So far there have not been any successful attempts to find new funding for the development banks like DFCK. The idea of issuing externally guaranteed domestic bonds, backed by the repayment streams of project loans has been discussed, but not attempted. (There was one attempt by ICDC to issue stocks for an investment trust in 1979.) It may not be possible to find guarantors for such a scheme given the asset quality problems of the development banks. While the financial situation in most of the development banks and parastatal lending institutions is weak, these represent most of the term lending in the economy.

The National Social Security Fund, at the end of 1983, had a portfolio of KSh 8.1 billion in assets. About two thirds of its portfolio is held in government stock. NSSF has held a large amount of money on deposit in NBFIs in the past, and has been attempting to withdraw those funds.

The Post Office Savings Bank (POSB) specialized in collecting small deposits at over 300 post offices throughout Kenya. There are also two independent POSB branches in Nairobi. The POSB attracts small savers with a lower minimum initial deposit than required by commercial banks. The minimum POSB deposit was KSh 40 in 1984. Since 1978, it has been government policy to pay the same interest rate on POSB savings deposits as the rate paid by commercial banks. The POSB has also tried to compete for deposits by introducing new savings programs, such as the bearer premium bond scheme. Another scheme is available for people with formal sector employment with automatic payroll deductions. This scheme grew rapidly and reportedly got about five million shs. in deposits per month in 1982. The POSB had over one million accounts by the end of 1982. There is a maximum deposit limit of KSh 250,000 with the POSB because there is no income tax paid on the interest earned. However, the maximum is irrelevant for all but a very few, since any family can have several accounts, one for each family member. While the Post Office Savings Bank has the advantage of convenience, the POSB also has withdrawal restrictions that may be disincentives for small savers. (A customer cannot withdraw more than 1,000 shs. per week from a

87

post office branch.) The withdrawal restrictions are necessary because savings records are not kept in the local post offices.

Savings and credit cooperative societies are an alternative for savers and borrowers who have formal-sector employment. This program was initiated in 1964 but grew slowly in the early years. The number of societies and total membership were growing rapidly by the early 1980s. Most societies are operating in Nairobi but now spreading to cover businesses in other urban areas. The societies are organized at the place of employment. Savings are not paid interest but used to qualify for borrowing facilities. Some of the savings and credit societies are plagued with management problems and corruption. An effort has been made to extend savings and credit facilities to rural areas through the cooperative saving scheme (CSS). Also, households in some areas of the country are organized in informal savings and credit societies. A more detailed discussion of savings facilities is given in Paulson, 1984.

b. Insurance Companies

There are 52 firms in the insurance industry, but the volume of business is small. Most insurance companies are subsidiaries of foreign companies. The regulatory structure was changed in January 1987. Under the new insurance bill, a Commissioner of Insurance will have the power to license and supervise the insurance companies.

There are 16 companies providing life insurance, and it appears that life insurance companies could be an important source of term finance. Total aggregate assets in the life insurance industry rose from KSh 1.17 billion in 1976 to KSh 2.84 billion in 1982. More recent data are not available. In 1982, about 17% of life insurance funds were held in banks and NBFI, 13.5% was loaned to the private sector, 7.2% was loaned for real estate, and 5.5% was held in government securities and bills.

There are 37 general or nonlife insurers. Several of the new general insurers set up in recent years are undercapitalized and it is estimated that up to 20% of these companies need to be closed. Competition has pushed the premiums down, losses have increased and some companies are close to insolvency. The funding base for the non life insurance is shorter term than the life insurance companies. While the proportion of funds held in banks and NBFIs fell from 61% in 1976 to 38% in 1982, this still shows a high degree of liquidity. In 1982, only 6% of the funds were lent to the private sector, with an additional 1% in loans to the manufacturing sector. About 2% of funds were held in government securities and bills. Market losses of nonlife insurance companies have also increased in recent years.

Under the Insurance Act of 1987, 25% of life insurance funds and 20% of nonlife insurance funds must be placed in securities of the government, statutory bodies, or other local authorities. A significant proportion, 65% for life insurance companies and

88

30% for nonlife insurance companies can be distributed among government securities, statutory bodies, mortgages, debentures secured by Kenyan immovable property, stock and bonds of companies traded on the stock exchange, life assurance policy loans, deposits with banks and NBFIs, and titles to Kenyan property. The companies are specifically prohibited from investing in private companies in any manner, and existing holdings must be divested within the grace period. The companies are further restricted from investing in any type of venture capital projects. The shortage of investment instruments and publicly traded shares means that funds in the insurance industry are not being fully utilized to provide term financing.

c. The Money Market

There is little money market activity except trading Treasury Bills. (Money market instruments are defined as instruments with maturities of less than one year.) The government sells 91-day KSh 100,000 Treasury Bills weekly through the Central Bank. Interest rates are set by the GoK. The Treasury Bill market is highly illiquid, as secondary market trading of bills is not permitted. Bill discounting with the Central Bank is legal, but strongly discouraged. Most T-Bills are held by commercial banks, NBFIs, the POSB, and the NSSF. Financial institutions hold Treasury Bills to meet the liquidity requirement set by the Central Bank.

The private sector uses a limited range of short-term financing instruments, such as crop finance bills, import and export bills, and promissory notes. Financial institutions will advance credit against short-term financial instruments, but have not developed a market for short-term lending instruments. The financial institutions rarely trade short-term instruments even though there are no legal barriers to such trades. Financial institutions developed an informal interbank overnight market for cash needed to meet the liquidity requirement of the Central Bank. Interbank rates are negotiated and reflect market forces.

Kenya needs to explore the possibility of expanding into other private-sector instruments such as bankers acceptances, commercial paper, and negotiable certificates of deposit. Kenya also needs more flexibility in the Treasury Bill market such as allowing secondary trading in Treasury Bills. A limited T-Bill auction was started in 1986 for the longer-term government bonds discussed below. If that auction process proves workable, Kenya might be willing to consider using an auction mechanism for the 91-day Treasury Bills. Another innovation to be considered would be to issue smaller denomination T-Bills to increase the pool of institutions on the demand side of the market.

d. Venture Capital Firms

Industrial Promotion Services (IPS), a venture capital-equity finance company, was formed 24 years ago by members of the Ismaili community of Kenya. To date IPS has invested in 20

84

firms, of which seven have been divested. In addition to internal funding, IPS manages a credit line from USAID and has a KSh 25 million cofinancing facility with the IFC. USAID has allocated a $3 million line of credit and $275,000 for technical assistance for IPS under the Private Enterprise Development Program approved in 1987. Currently IPS has approximately KSh 40 million invested in eight projects. The clients are primarily medium-size companies with assets of $1 to $4 million. The equity position taken by IPS varies between 12% and 40% per project. Equity shares will be sold in the projects within 7 to 10 years. The targeted internal real rate of return is 20%. IPS can also provide debt financing to the companies in which it has an equity position.

The Kenya Equity Capital Company is a planned equity capital company that is slated to receive funds from USAID.

e. The Capital Market

The capital markets for medium- and long-term securities have been stagnant in recent years. The GoK issues long-term loan stocks with maturities ranging from 5 to 20 years. The stocks are issued at fixed interest rates which have not been competitive with alternative assets. In principle, secondary trading of these securities is allowed through the Nairobi Stock Exchange, but yields are so unattractive that there is no secondary market. As of April 30, 1984, the National Social Security Fund and the Central Bank held 80% of the outstanding government stocks and public bodies held 93% of these securities. In the 1986-87 Budget the government introduced two new medium- and long-term Treasury bonds to absorb the liquidity arising from the improving balance of payment situation. The two-year bond was offered to individuals, commercial banks, and NBFIs. The five-year bond was designed for insurance companies and pension funds. These new Treasury bonds represent a move away from the practice of fixing both the coupon rate and the price of the government stocks in advance of sale. The new Treasury bonds were sold in a competitive auction process. This experiment was reportedly not very successful because there is still not a secondary market.

The Nairobi Stock Exchange was established in 1954 by six stock brokerage firms. One of the firms, Blair and Dyer; closed following the collapse of the Continental banking group, so now there are five. These are limited service firms and act as agents for clients. Stock market bids and transactions are not public and are carried out through daily call-over meetings among the firms. Insurance companies, pension funds, investment trusts, and the larger banks are the major clients.

The stock market structure is largely a residual of past, rather than recent, activity. The number of companies listing equity securities declined from the time the Exchange was formed to only 55 companies by mid-1984. There are 73 issues of ordinary and preference stock and 47 different issues of

90

government and Nairobi City Council stocks listed. Trading activity fell from 16,829 trades in 1973 to 5,496 trades in 1979, the last time official figures were published. It was estimated that there were only 3,500 to 4,000 trades in 1985. As of June 1985, the estimated market value of all traded shares outstanding was KSh 4,320 million and KSh 17,060 million in government bonds.

Most companies in Kenya are privately owned, frequently by families. There are no corporate tax advantages and several disadvantages to public ownership, including information reporting requirements. Tax treatment of new issues is not favorable. The difference between the sales price and the par value is treated as taxable capital gain, underwriting expenses are not tax-deductible, and dividends are double-taxed. Another obstacle has been government control of the pricing of new issues. The Capital Issues Committee was established in 1971 under the Ministry of Finance and Planning to oversee the pricing, timing, and allocation of the new private-sector securities. The CIC was recently replaced by a Capital Market Development Authority (CMDA) which regulates rather than sets prices, and this change may remove some obstacles for capital market development.

There was only one primary issue of stock and one secondary issue in the period 1980 to 1986. The primary issue was for Jubilee Insurance Ltd. in 1984, with 800,000 ordinary shares of KSh 5 each, priced at 14 1/2 shs. The secondary issue was by Barclays Bank in 1986, 5 million ordinary shares of KSh 10 each, priced at 16 shs. per share. Both issues were oversubscribed, evidencing strong demand for the stock of established companies.

There is little doubt that there is sufficient demand to support at least a small stock exchange in Kenya. Recent changes in government policy will bolster the demand for stocks: for example, insurance companies are only allowed to invest in stocks of firms traded on the stock exchange. However, the short-term potential for stock market development should not be over-estimated. The two new issues of stocks in the last few years were for well-established companies, and very few companies have such credibility. Corporate financial reporting requirements are weak, public disclosure is spotty and the accounting profession is of variable reliability.

Government policies could encourage some activity on the supply side of the stock market. The new Insurance Act of 1987 requires foreign-controlled insurance firms to increase indigenous ownership. Some of these companies may consider public ownership. The 1984 Jubilee issue and the 1986 Barclays issue may serve as models for small investor share ownership schemes. However, the government has not provided tax incentives to encourage firms to go public.

All in all, there are significant gaps and obstacles in the stock market. There are a host of institutions, e.g. traders, brokers, accountants, and investment bankers, etc. that are in

91

short supply, and market information needs to be made more reliable. While needed reforms must be encouraged, developing a viable capital market is likely to be a long-term prospect.

g. Rural Financial Markets

There are three main sources of rural credit: the Agricultural Finance Corporation (AFC), the commercial banks, and the cooperatives. The commercial banks are well represented in the larger rural centers and the government has pushed banks to move into less prosperous regions. Almost all branches outside the major regional centers belong to KCB, Standards, and Barclays.

The major problems of the parastatal AFC are: (a) concentration of benefits in some very large loans, (b) poor internal accounting, (c) low recovery rates, and (d) lax collection efforts. Although AFC does have small targeted credit programs for smallholders and unsecured lending, most of its funds go to commercial farmers, and much goes to the largest farmers. There is a great deal of overlap in the clientele served by banks and AFC in rural areas. A sample of rural commercial bank loans examined in Paulson (1984) found that rural banks were making small or medium-sized loans to middle as well as upper-income clients. The banks may not do as good a job of serving medium-scale nonagricultural enterprises. David and Wyeth (1979) found that the size distribution of bank loans is most equal for the entrepreneurs engaged in farming only and most unequal for businessmen with no farm interests.

Past research has suggested that there are several "imperfections" in rural markets in Kenya that slow development of financial markets. Most financial institutions require either land title or wage employment or both for loan eligibility. The problems with the land and labor markets may be significant obstacles to bank operations in some areas.

Collier (1983) used 1974-785 survey data to demonstrate the 'malfunctioning' of rural factor markets, particularly land and labor. He argued there were market failures because smallholders could not engage in complex contracts for labor and land to rationalize factor use in production. He argued that complex contracts were not used in rural Kenya because of the noncapitalist conception of property rights over land, combined with widespread absenteeism among land owners. In this environment land owners cannot monitor labor input, making labor hiring inefficient, and land hiring is precluded by the limited nature of the rights of land holders.

Another constraint on rural land markets is that much of the land has not been registered for private ownership. But even in areas where the land has been registered, land markets function poorly. The district land control boards were established in 1967 to safeguard the access of smallholders to land. Also, the banks report that in some areas, it is almost impossible to sell land

9V

seized after borrowers defaulted on loans, making collateral worthless. Land auctions are boycotted and the social system will not validate the sale of land owned by a member of the community.

g. Informal Credit Markets

Informal credit markets frequently evolve contractual arrangements to compensate for incomplete markets. Little information is available on informal credit markets in Kenya, and most is stylistic. Abdi (1977) reported there was no indigenous money-lending class in East Africa and most informal flows of credit are within the extended family. The only other forms of credit used were commodity loans that were repaid in kind or exchanged later for other commodities. The flow of funds within the family and friendship network may be extensive. Goran Hyden (1983) argues that the social and economic organization, which he terms the "economics of affection" plays an important role in basic survival, social maintenance, and development. The social organization provides support systems that perform some of the functions of credit markets. Abdi's observation that there is little informal credit available, except from family and friends, does not seem to hold in all areas and may be changing over time. Kanoga (1978) found there were local money lenders in the Karatina area, but borrowing from them was very unpopular and socially unacceptable. Haugerud (1981A) found evidence of some alternative credit sources in the Embu area of Eastern Kenya. Some suppliers credit is available for agricultural inputs from shopkeepers. Moock (1974) found merchants were providing credit to farmers in Vihiga and interest rates were generally high. While these studies did document some informal suppliers credit, the supply does seem to be limited. There have also been some indigenous institutions developed to provide pooled savings as credit. Von Pischke (1974) found some forms of working relationships and contracts which provided traditional credit.

h. The Legal System

The operations of the legal system in Kenya leave considerable uncertainty about property rights in Kenya. Within the legal system, there are frequent disputes over jurisdiction and responsibilities. The banks have become increasingly reluctant to accept land deeds as collateral because of uncertainty about land property rights. Uncertain property rights increase the risk of standard lending contracts and reduce the incentives for financial innovation. The uncertainty about the legal system may help explain why the financial institutions have focused on competition through branching in Nairobi rather than experimenting with new lending instruments.

i. The Tax System

The tax system has been an obstacle to capital market development in several ways. Short-term deposit facilities have a tax advantage over long-term equity investment. For example,

93

deposits with the POSB and the Housing Finance Company are tax free and offer rates of return up to 30% to 40% on pre-tax basis. Long-term savings through private pension funds are not tax deductible. This slows the growth of capital funds because long-term pension funds usually hold long-term securities. Second, taxes are high on capital gains and dividends, e.g. there is a requirement that an investor must hold at least 12.5% of the stock of a company to avoid triple taxation of the dividends. Third, the government has been hesitant to approve capital market innovations for fear of losing part of the tax base. The government has cited tax collection concerns as a reason for not allowing new financial instruments for the money market.

4. CONCLUSIONS

The most immediate issue for Kenya is stability of financial institutions. There are several insolvent NBFIs still operating. Closing the institutions has become a sensitive political issue, since the new NBFIs were intended to decrease dependence on foreign financial institutions. However, letting the insolvent financial institutions operate will erode public confidence and may force customers back to the large foreign financial institutions. In the short run the Central Bank needs to deal with closing the insolvent institutions and implementing rigorous quality standards for the other institutions. The way in which the Central Bank deals with this immediate situation will have ramification for the longer-term prospects for innovations.

Regulations have been rationalized somewhat in the 1980s, and real interest rates have been positive since 1983. Further interest rate deregulation will allow more flexibility but may not bring a large response in the financial sector. Recent experience suggests that market structure has been a factor in the lack of competition and innovation. Competition among the new financial institutions was intense during 1982-84. New instruments were introduced, interest rate competition was keen, several banks and NBFIs attempted to improve customer services. The competition had obvious benefits for generating innovation in the sector, but led to excessive risk-taking by some institutions followed by failures. The period of intense competition did not last long enough to change fundamental practices and behavior. There is now a dilemma for regulation of the financial sector. Allowing poorly capitalized financial institutions to continue operating will increase competition, but will lead to instability.

Credit allocation is concentrated in the modern sector, mostly in Nairobi. Very little is available to small ventures, and almost none to the informal sector. Import substitution protection policies are still intact, and economic and financial rates of return diverge. The government has tried to address this divergence through the parastatals with targeted subsidized credit and by establishing agricultural lending targets for the commercial financial institutions. This strategy has not worked,

94

and much of the credit has been allocated on political rather than economic grounds. The parastatals and development banks are periodically short of funds and many have low repayment rates. If the government is going to rely on the commercial financial institutions, the divergence between economic and financial returns on investment should be reduced. But price policies are not the only obstacle for increasing the activities of commercial financial institutions. Unpredictable rulings by the judiciary increases uncertainty for all parties in contracts. This makes financial innovation risky and costly.

The evidence on the ability of the banks to take a leading role in the development process is not encouraging. The Kenyan banking system is fundamentally a conservative banking system. Credit allocation is based on the value of the security, most credit is short term, and many of the foreign banks are anxious to limit their involvement in the Kenyan economy. Even the government banks have maintained many British banking practices. The banks are primarily passive suppliers of short-term credit on standardized terms. The system serves an established clientele with overdraft facilities that are routinely renewed. Access to credit is limited for new borrowers and small ventures. These problems do not originate in the financial sector, but rather in the relative price structure that arises from the import substitution development strategy. Until the relative price structure is changed there is little reason for the commercial financial institutions to extend credit outside the formal protected sectors.

Equity financing is very limited. While there are constructive steps that can be taken to facilitate development in equity capital markets, unreliable market information is going to be very problematic.

Appendix B.1: USAID Projects in Kenya

USAID/Kenya is implementing a number of private sector development initiatives:

1. The Rural Private Enterprise Project provides grants to private voluntary organizations to assist informal sector enterprises and provides credit to small- and medium-sized enterprises through commercial lenders.

2. The Rural Private Enterprise Project will provide $24 million in loans through commercial banks to rural businesses. In addition the project will support the expansion of an on-going equity capital firm, Industrial Promotion Services (Kenya) Ltd., and support a new equity venture capital firm. The total cost of the project is estimated at $71.3 million, with an AID contribution of $25 million, of which $9.19 million will be for equity capital. The new equity capital firm, Kenya Equity Management-Kenya Equity Capital Ltd., is expected to mobilize capital from sources within Kenya, including the major financial institutions, in addition to the $6.19 million allocated by USAID. Details about the proposed new equity fund are given in USAID/ Kenya. "Private Enterprise Development Project." (615-0238), May 1987, p. 21-22.)

3. Project documents also listed several other planned USAID activities: establishing a refinancing facility in the Central Bank to give banks permanent access to funds for rural businesses; loan guarantee programs to ease the collateral constraints of small businesses, and the foreign exchange risk of private sector housing loans; and the development of an informal sector loans program, the Jua Kali Program, to provide working capital to the smallest businesses.

A plan to work on an export credit facility has been dropped.

96

Appendix B.2: Regulations on Commercial Financial Institutions

Interest Rate Guidelines. The Central Bank has kept real rates positive since 1983 and real rates are fairly high now. The maximum lending rate on commercial bank advances is 14%, while the maximum for NBFI has recently been reduced to 18%. The minimum deposit rate for banks and NBFI is 11%. The Central Bank has taken steps to make the rates more uniform across institutions. In November 1983, NBFIs were restricted to interest charges on reducing balances and prohibited additional fees or commissions.

Liquidity Ratios. The Central Bank imposes reserve requirements of between 15% and 24%. Liquid assets are defined as cash in the tills of banks, balances of banks with the Central Bank, Treasury Bills, and net interbank balances in Kenya and abroad. The reserve requirement has been used for credit control and as an implicit tax on financial institutions. Currently banks are required to meet a 20% liquid asset ratio and NBFI 24%. The liquidity ratio has frequently not been binding for the banks which tend to operate with a great deal of liquidity. For example, in March 1986 the aggregate bank liquid asset ratio was 24.5%, while the required ratio was 20%. The liquidity situation tends to be much tighter for the NBFI, and some NBFI are far below the required level of 24%.

Sectoral Credit Guidelines. Both the commercial banks and NBFI are encouraged to meet lending targets to agriculture. Banks are to lend at least 17% of deposit liabilities to the agricultural sector and the target for NBFI is 10%. This policy has not been enforced and the many financial institutions simply reclassify loans as agricultural. This guideline probably distorts the data more than the actual allocation of credit.

Capital Adequacy. The 1985 Amendments to the Banking Act raised the capital standards. For a locally incorporated bank the minimum capital was raised from KSh 10 million to 15 million and for NBFI from KSh 5 million to KSh 7.5 million. Capital required for a bank incorporated outside Kenya was raised to KSh 150 million and KSh 75 million for a NBFI. Financial institutions were given until May 1987 to meet the new capital requirements. The ratio of additional required capital to deposits was raised from 5% to 7.5% of deposits. Financial institutions were given until May 16, 1988 to meet this requirement.

Lending Restrictions to Multinationals. The domestic currency borrowing of multinational firms is restricted under exchange controls to 20% of the initial equity capital in Kenyan 1986-87 shillings. In the 19[illegible]/7 Budget Speech the Minister of Finance announced his intention to relax these restrictions to link access to shilling loans to the proportion of equity owned by Kenyans and the size of duties paid on imported capital equipment.

97

Commercial Banks in Kenya

		Date Started
1.	Standard Bank	1910
2.	Barclays Bank of Kenya Ltd.	1916
3.	AlgemeneBank Nederland N.V. (A.B.N.)	1951
4.	Bank of India	Oct. 17, 1953
5.	Bank of Baroda	Dec. 14, 1953
6.	Habib Bank Ltd.	March 16, 1956
7.	Cooperative Bank of Kenya Ltd.	June 1965
8.	Commercial Bank of Africa Ltd.	Dec. 13, 1967(1958)
9.	National Bank of Kenya Ltd.	Sept. 30, 1968
10	Grindlays Bank Intern. (Kenya) Ltd.	Dec. 8, 1970
11.	Kenya Commercial Bank Ltd.	Dec. 9, 1970
12.	Citibank N.A.	Aug. 5, 1974
13.	First National Bank of Chicago	1974
14.	Bank of Credit and Commerce International (Overseas) Ltd.	April 1977
15.	Habib Bank A.G. Zurich	April 7, 1978
16.	Middle East Bank Ltd.	July 27, 1981
17.	Banque De L'Indochine et De Suez (IndoSuez Bank)	July 27, 1981
18.	Bank of Oman	April 1982
19.	Pan African Bank	Nov. 19, 1982
20.	Union Bank	1983
21.	Continental Bank	1983
22.	Biashara Bank	
23.	Societe Generale de Banque	
24.	Trade Bank	
25.	Bank of America	
26.	Bank of Nova Scotia	

Non-Bank Financial Institutions Affiliated with Commercial Banks

		Date Licensed
1.	National Industrial Credit (E.A.) Ltd.	May 2, 1959
2.	Savings and Loan Kenya Ltd. (licensed under the Building Societies Act)	1965(1949)
3.	Commercial Bank of Africa Finance Co. Ltd.	1967
4.	East Africa Acceptances Ltd.	1968
5.	Grindlays International Finance (K.) Ltd.	Nov. 13, 1970
6.	Kenya Commercial Finance Company Ltd.	Aug. 25, 1971
7.	First Chicago (K) Ltd.	May 16. 1974
8.	Kenya National Capital Corporation Ltd.	Nov. 20, 1974
9.	Continental Credit Finance Co. Ltd.	May 18, 1978
10.	Habib Zurich Finance Co. Ltd.	Sept. 18, 1978
11.	Pan African Credit and Finance Ltd.	Nov. 18, 1980
12.	Bank of Credit & Commerce Finance (K) Ltd.	1980

Non-Bank Financial Institutions Not Affiliated with Commercial Banks

1.	East African Building Society (licensed under the Building Societies Act)	1959
2.	Credit Finance Corporation Ltd.	Aug. 5, 1969 (1955)
3.	Mombasa Savings and Finance Ltd.	June 25, 1970
4.	Akiba Loans and Finance Co. Ltd.	April 24, 1972
5.	Diamond Trust of Kenya Ltd.	Aug. 19, 1977 (1946)
6.	Kenya Finance Corporation Ltd.	April 6, 1978
7.	Housing Finance Company of Kenya Ltd.	July 1, 1979
8.	Jimba Credit Corporation Ltd.	Jan. 16, 1980
9.	Investments & Mortgages Ltd.	May 27, 1980
10.	Mercantile Finance Co. Ltd.	May 30, 1980
11.	Southern Line (Southern Credit Finance)	Oct. 4, 1980
12.	Lima Finance Ltd.	Dec. 11, 1980
13.	Industrial Development Bank	July 1, 1981
14.	Nationwide Finance Co. Ltd.	Oct. 16, 1981
15.	Capital Finance Ltd.	Oct. 16, 1981
16.	Middle Africa Finance Co. Ltd.	Nov. 17, 1981
17.	Rural Urban Credit Finance Ltd.	Feb. 1, 1982
18.	Arab Africa Finance Ltd.	Feb. 4, 1982
19.	Thabiti Finance Company Ltd.	Feb. 26, 1982
20.	Business Finance Ltd.	June 17, 1982
21.	Home Savings and Mortgages Ltd.	April 30, 1982
22.	Union Credit Finance Co.	Feb. 1, 1983

Note: This list includes only NBFI licensed before mid-1983.

BIBLIOGRAPHY

a. Books and Monographs

Abdi, Ali Issa. Commercial Banks and Economic Development: The Experience of Eastern Africa. New York: Praeger Publishers, 1977.

African Confidential. Vol. 27, No. 18, Sept. 1986.

Ahamed, Liaquat. "Short-Run Macroeconomic Policy in Kenya." draft working paper from the Country Policy Department, World Bank, March 1984.

Arowolo, Edward A. "The Development of Capital Markets in Africa with Particular Reference to Kenya and Nigeria." IMF Staff Papers. Vol. 18, No. 2, July 1971, pp. 420-469.

Binswanger, Hans P. and Mark R. Rosenzeig. "Behavioral and Material Determinants of Production Relations in Agriculture." The World Bank, Agriculture and Rural Development Department, Discussion Paper No. 5, 1983.

Central Bank of Kenya. "Quarterly and Economic Review." various issues.

Central Bank of Kenya. Central Bank of Kenya: It's Evolution, Responsibilities and Organization. Sept. 1986.

Central Bureau of Statistics. Economic Survey. various years.

Collier, Paul. "Malfunctioning of African Rural Factor Markets: Theory and a Kenyan Example." Oxford Bulletin of Economics and Statistics. Vol. 45, No. 2, May 1983, pp. 141-172.

David, Martin and Peter Wyeth. "Kenya Commercial Bank Loans in Rural Areas: A Survey." University of Nairobi, Institute for Development Studies, Working Paper No. 342 and 342A, August 1978.

David, Martin. "Equity, Profit, and Risk-an Evaluation of the Role of a Commercial Bank in Redistribution with Growth." Working Paper, January 1979.

Dell'Amore, G. (ed.) Banking Systems in Africa. Lombarde: Cassa di Risparmio delle Provincie, 1971.

Dillon, B. "Financial Institutions in Kenya, 1954-1971." University of Nairobi, Institute of Development Studies, Working Paper No. 61, Sept. 1972.

Donaldson, G.F. and J.D. Von Pischke. "A Survey of Farm Credit in Kenya." A.I.D. Spring Review of Small Farmer Credit. Vol. 7, Feb. 1973.

180

Engberg, H.L. "Commercial Banking in East Africa 1950-1963." Journal of Modern African Studies. Aug. 1965, pp. 175-200.

Frediani, Lorenzo. The Liquidity Policy of Deposit Banks in Kenya. Milan: Cassa Risparmio Provincie Lombarde, 1975.

Gulhati, Ravi and Gautam Datta. "Capital Accumulation in Eastern and Southern Africa." World Bank Staff Paper No. 562, 1983.

Haugerud, Angelique. "Development and Household Economy in Two Eco-Zones of Embu District." University of Nairobi, Institute for Development Studies, Working Paper No. 382, July 1981. (1981A).

Haugerud, Angelique. "Economic Differentiation Among Peasant Households: A Comparison of Embu Coffee and Cotton Zones." University of Nairobi, Institute for Development Studies, Working Paper No. 383, July 1981. (1981B).

Hyden, Goran. "The Changing Role of the African Administrator." in Rweyemamu and Hyden (eds.), A Decade of Public Administration in Africa. 1975, pp. 1-12.

_____, Beyond Ujamaa: Underdevelopment and an Uncaptured Peasantry. London: Heinemann, 1980.

_____, No Shortcuts to Progress: African Development Management in Perspective. Berkeley: University of California Press, 1983.

Kanoga, Ephraim Mandia. Informal Credit in Mathira, Nyeri District, Central Kenya: A Case Study of Rural Informal Credit in Kenya. M.A. Thesis, University of Nairobi, June 1978.

Killick, Tony. "Kenya, 1975-1981." in Killick, Tony (ed.) The IMF and Stabilization: Developing County Experiences. London: by Gower Publish Co. Ltd. for the Overseas Development Institute, 1984, pp. 164-216.

Livingstone, Ian. Rural Development, Employment, and Incomes in Kenya. Addis Ababa: International Labour Office, 1981.

Lomas, P.K. "The Nairobi Stock Exchange and the Trend of Ordinary Share Prices since 1955." East African Economics Review. Vol. 2, 1981.

Moock, Peter Russell. Managerial Ability in Small-Farm Production: An Analysis of Maize Yields in the Vihiga Division of Kenya. PhD dissertation. Columbia University, 1973.

Obong, George Samuel Okelo. Kenya's Financial Development: An Analysis from East African Currency Board to Central Banking, 1919-1971. Lincoln, Nebraska: Ph.D. Dissertation, University of Nebraska, 1974.

Parkinson, John M. "The Nairobi Stock Exchange in the Context of Development of Kenya." Savings and Development. Vol. 8 No. 4, 1984, pp. 363-372.

Paulson, J.A. The Structure and Development of Financial Markets in Kenya: An Example of Agricultural Finance. PhD dissertation, Stanford University, 1984.

Shipton, Parker McDonald. Land, Credit, and Crop Transition in Kenya: the Luo Response to Directed Development in Nyanza Province. PhD. dissertation, University of Cambridge, 1985.

Vinnai, Volker. "The Role of Development Finance Company of Kenya in the Industrialization Process." University of Nairobi, Institute of Development Studies. Discussion Paper No. 180, 1972.

Von Pischke, J.D. "Credit Use and Development on Nineteen Murang'a Farms, 1969-1973." University of Nairobi, Institute for Development Studies, January 1974.

_____, "A Penny Saved...Kenya's Cooperative Savings Scheme and Some Related Aspects of Rural Finance." University of Nairobi, Institute for Development Studies, Working Paper No. 204, January 1975.

_____, "Specialized Farm Credit Institutions: A Model of Supply-Leading Finance for Farmers in Low Income Countries." University of Nairobi, Institute for Development Studies, Working Paper No. 341, August 1978.

_____, "A Description of the Cooperative Production Credit Scheme." University of Nairobi, Institute of Development Studies. Discussion Paper No. 80, 1972.

_____, "Country Survey: Kenya". A.I.D. Spring Review of Small Farmer Credit. Vol. 17, June. 1973.

_____, "A Critical Survey of Approaches to the Role of Credit in Smallholder Development." University of Nairobi, Institute of Development Studies. Discussion Paper No. 233, 1976.

Weisel, Peter, et al. "The Vihiga Maize Credit Program." A.I.D. Spring Review of Small Farmer Credit. Vol. 7, Feb. 1973.

b. <u>Program Documents and Project Appraisals</u>

Deloitte, Haskins & Sells. "Report on Non-Bank Financial Institutions for the United States Agency for International Development." Dec. 1984.

Hunt, Robert W. and S.M.A. Mirero. "End of Project Evaluation of the Small Business Scheme of the National Christian Council of Kenya: A Report to the Agency for International Development, Bureau of Science and Technology." March 1985.

I.F.C. "Report and Recommendation on the Development of the Money and Capital Markets in Kenya." Oct. 1984. (The Central Bank of Kenya and the International Finance Corporation collaborated on this report on security market development between April and June 1984).

O'Regan, Fred M., Thomas Schmidt, and Jennefer Sebstad. "Kenya Rural Private Enterprise Project: Social Soundness Analysis, NGO Assessment, and Recommendations on Project Design." Report to USAID/Kenya. June 10, 1983.

Price Waterhouse and International Resources Group Ltd. "Report and Recommendations for Assistance in Private Sector Export Promotion." Jan. 1986.

Price Waterhouse and International Resources Group Ltd. "Kenya Equity Finance Study." Jan. 1986.

SRI International. Prospects and Strategies for Investment Promotion in Kenya. Vol. I: The Investment Climate of Kenya. Jan. 1986.

USAID/ Kenya. "Rural Private Enterprise Development Project." (PED) (615-0220), Aug. 1983.

USAID/Kenya. "Private Enterprise Strategy Statement." Nairobi: Sept. 1985.

USAID/ Kenya. "Private Enterprise Development Project." (PED) (615-0238), May 1987.

Wescott, Clay G. "Small-Scale Lending in Kenya." in Part B of Brown, Jason. "Small-Scale Bank Lending in Developing Countries: A Comparative Analysis." Prepared for the Employment and Small Enterprise Division, Office of Rural and Institutional Development, USAID, Grant No. DAN-0600-G-SS-2107-00, April, 1984. (For the purpose of this survey, a small-scale loan is defined as using the local definition so the results are not directly comparable across countries. The main report includes very brief summaries on the Cameroon and Kenya as well as several other non-African countries. The full case studies were not available to the research team.)

World Bank. "Kenya-Agricultural Sector Management Project." IDA/R86-79" (P-4236-KE) June 2, 1986.

World Bank. "Economic Development and Urbanization Policy." Vol. I and II. Dec. 13, 1985.

World Bank. "Kenya Policies and Prospects for Restoring Sustained Growth of Per Capita Income." March 24, 1986.

Arthur Young. "Summary of Financial Markets Survey." March 1986.

THE WEFA GROUP

KENYA

OCT 13, 1987

MACROECONOMIC VARIABLES

	80	81	82	83	84	85	86
GROSS DOMESTIC PRODUCT, MILL US$	5264.9	6046.7	6795.9	7651.9	8492.2	9483.6	NA
GDP PER CAPITA, US$	315.8	348.7	376.7	407.7	434.6	466.5	NA
EXPORTS, FOB, MILL US$	1388.9	1182.7	1045.4	979.2	1082.4	977.1	1199.6
CURRENT ACCT. BAL., MILL US$	-887.4	-722.9	-518.0	-133.5	-195.2	-210.6	NA
TOTAL EXTERNAL DEBT, MILL US$	2678.2	2710.1	2824.5	2928.1	3052.0	3263.1	NA
CONSUMER INFLATION, 1980=100	100.0	111.8	134.7	150.2	165.4	187.0	194.4
US$/SHILLING, PERIOD AVERAGE	0.13	0.11	0.09	0.08	0.07	0.06	0.06
POPULATION, MILL.	16.7	17.3	18.0	18.8	19.5	20.3	NA

MONETARY SURVEY

	80	81	82	83	84	85	86
MONEY SUPPLY, M2, BILL. SHILLINGS	16.1	18.3	21.4	22.4	25.3	26.8	35.7
CONSUMER INFLATION, 1980=100	100.0	111.8	134.7	150.2	165.4	187.0	194.4
WHOLESALE PRICE INDEX,1980=100	NA	NA	NA	NA	NA	NA	NA
DISCOUNT RATE	8.0	12.5	15.0	15.0	12.5	12.5	12.5
COMMERCIAL PRIME RATE	NA	NA	NA	NA	NA	NA	NA
GOVT. BOND YIELD, MEDIUM TERM	NA	NA	NA	NA	NA	NA	NA
DEGREE OF MONETIZATION	0.3	0.3	0.3	0.3	0.3	0.3	NA

104

KENYA

CONSOLIDATED BALANCE SHEET OF
COMMERCIAL BANKS
MILLION SHILLINGS

ASSETS	80	81	82	83	84	85	86
RESERVES	1204.0	985.0	1834.0	1323.0	1635.0	2272.0	3420.0
FOREIGN ASSETS	555.0	706.0	627.0	609.0	632.0	640.0	737.0
CLAIMS ON GOVT.	1542.0	2133.0	2544.0	2121.0	3093.0	2407.0	5252.0
CLAIMS ON PRIVATE SECTOR	11759.0	13025.0	14357.0	15380.0	16944.0	19491.0	22684.0
LIABILITIES							
DEMAND DEPOSITS	5814.0	6374.0	6798.0	7640.0	8901.0	9219.0	11314.0
TIME AND SAVINGS DEPOSITS	7702.0	8872.0	10735.0	10953.0	12198.0	13976.0	18172.0
FOREIGN LIABILITIES	520.0	440.0	561.0	626.0	813.0	814.0	853.0
GOVT. DEPOSITS	246.0	212.0	566.0	440.0	613.0	928.0	961.0
CREDIT FROM CENTRAL BANK	197.0	75.0	0.0	4.0	165.0	165.0	1.0
CAPITAL ACCOUNTS	1360.0	1718.0	1964.0	2099.0	2454.0	2806.0	3386.0
VALUATION ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
OTHER ITEMS, NET	-267.0	-376.0	-263.0	-474.0	-727.0	-779.0	196.0

BALANCE SHEET OF CENTRAL BANK

ASSETS	80	81	82	83	84	85	86
FOREIGN ASSETS	3784.0	2577.0	2957.0	5459.0	6444.0	6807.0	7115.0
CLAIMS ON GOVT.	2663.0	4955.0	8725.0	7028.0	7089.0	8884.0	11260.0
CLAIMS ON OFFICIAL ENTITIES	NA	NA	NA	NA	NA	NA	NA
CLAIMS ON COMM. BANKS	NA	NA	NA	NA	NA	NA	NA
CLAIMS ON SPECIAL BANKS	NA	NA	NA	NA	NA	NA	NA
LIABILITIES							
RESERVE MONEY	4422.0	4605.0	5787.0	5659.0	6304.0	7257.0	10132.0
OF WHICH							
CURRENCY OUTSIDE BANKS	3032.0	3569.0	3724.0	4083.0	4370.0	5038.0	6371.0
QUASI-MONEY DEPOSITS	NA	NA	NA	NA	NA	NA	NA
FOREIGN LIABILITIES	1967.0	2704.0	5190.0	6470.0	6637.0	8542.0	7238.0
CAPITAL ACCOUNTS	364.0	391.0	431.0	525.0	618.0	707.0	805.0
RESCHEDULING ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
VALUATION ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
OTHER ITEMS, NET	-431.0	-397.0	263.0	-167.0	-26.0	-926.0	81.0

KENYA

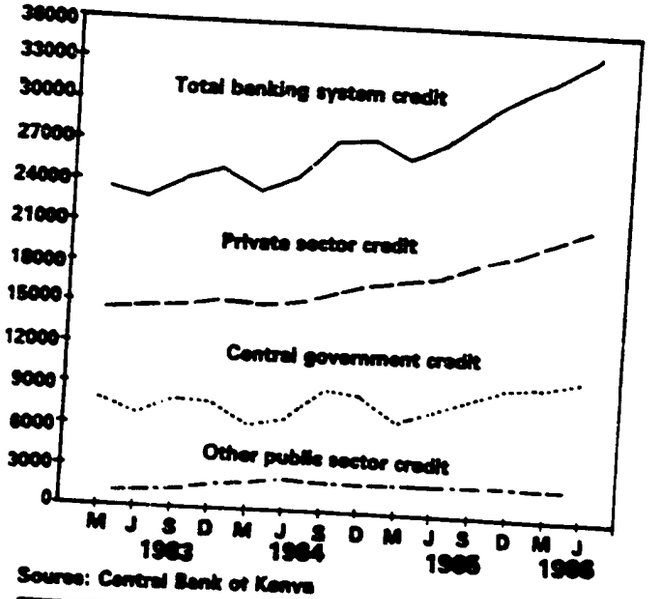
GOVERNMENT FINANCE
MILLION SHILLINGS

	80	81	82	83	84	85	86
DEFICIT(-)/SURPLUS(+)	-1122.0	-3897.0	-4462.0	-1597.0	-2710.0	-3775.0	NA
REVENUE	12508.0	13853.0	15137.0	15706.0	17844.0	19428.0	NA
EXPENDITURE	13839.0	18329.0	20070.0	17734.0	21259.0	23790.0	NA
FINANCING							
DOMESTIC	132.0	969.0	3748.0	3460.0	3118.0	2371.0	NA
FOREIGN	128.0	1216.0	815.0	123.0	-979.0	-1611.0	NA

INTERNATIONAL DEBT
MILL. US$

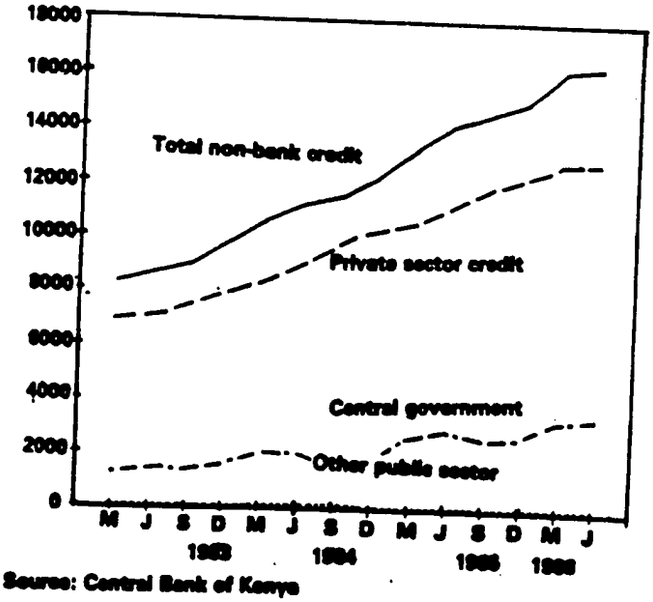
	80	81	82	83	84	85	86
TOTAL EXTERNAL DEBT, (EDT)							
LONG-TERM DEBT	2678.2	2710.1	2824.5	2928.1	3052.0	3263.1	NA
PUBLIC AND PUBLICALLY GUARANTEED	2241.2	2344.6	2439.7	2430.9	2623.7	2857.4	NA
PRIVATE NONGUARANTEED	437.0	365.5	384.8	497.2	428.3	405.7	NA
USE OF IMF CREDIT							
SHORT-TERM	638.0	466.0	334.0	402.0	369.0	470.0	NA
TOTAL LONG-TERM DEBT							
DEBT OUTSTANDING AND DISBURSED	2678.2	2710.1	2824.5	2928.1	3052.0	3263.1	NA
DISBURSEMENTS	562.5	439.6	391.8	299.5	508.9	270.8	NA
PRINCIPAL REPAYMENTS	119.6	157.7	184.0	183.1	210.5	243.6	NA
NET FLOWS	442.9	281.9	207.8	116.4	298.4	27.2	NA
INTEREST PAYMENTS	133.1	134.2	151.7	130.2	135.9	142.1	NA
NET TRANSFERS	309.8	147.7	56.1	-13.8	162.5	-114.9	NA
TOTAL DEBT SERVICE	252.7	291.9	335.7	313.3	346.4	385.7	NA
PRINCIPAL RATIOS							
TOTAL EXTERNAL DEBT							
EDT/XGS)							
EDT/GNP)							
INTERNATIONAL RESERVES							

DISTRIBUTION OF BANKING SYSTEM CREDIT
(shillings million)



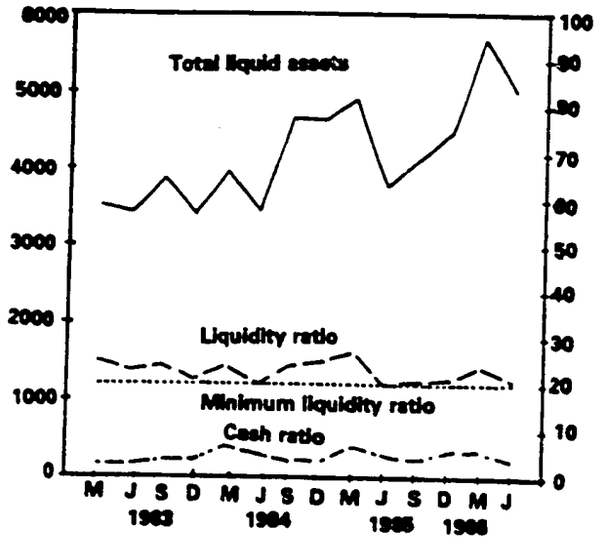
Source: Central Bank of Kenya

DISTRIBUTION OF NON-BANK CREDIT
(shillings million)



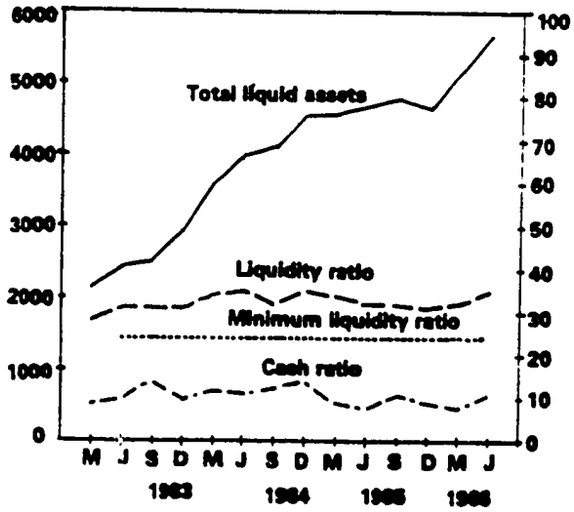
Source: Central Bank of Kenya

COMMERCIAL BANKS LIQUIDITY
(shillings million)



Source: Central Bank of Kenya

LIQUIDITY OF NON-BANK FINANCIAL INSTITUTIONS
(shillings million)



Source: Central Bank of Kenya

COMMERCIAL BANKS — ANALYSIS OF BILLS, LOANS AND ADVANCES
(shillings million)

End of	PUBLIC SECTOR		ENTERPRISES (PRIVATE AND PUBLIC)†									PRIVATE	
	Government*	Commercial Statutory Boards and other Public entities	Agriculture	Manufacturing	Building and Construction	TRADE: Export	TRADE: Import	TRADE: Domestic	Transportation	Financial Institutions	Other Business	HOUSEHOLDS etc.	Total
1965	136·16	—	138·80	117·78	22·34	—	444·02	—	25·96	91·76	131·68	42·12	1,151·72
1966	18·30	—	125·52	166·86	21·56	—	460·06	—	14·02	96·34	152·42	58·04	1,110·24
1967	26·00	—	186·50	218·88	30·38	—	514·86	—	22·34	77·78	223·72	58·88	1,380·04
New Series													
1967	23·78	40·28	132·96	244·46	29·80	208·08	214·62	181·38	22·90	72·80	131·74	80·44	1,380·04
1968	21·44	38·82	156·48	254·42	36·72	173·32	182·80	198·80	28·56	67·04	116·18	56·08	1,336·76
1969	12·12	22·30	172·38	302·86	43·64	160·38	167·28	204·88	58·20	68·74	121·60	76·82	1,400·80
1970	53·38	48·42	196·74	311·42	67·42	200·66	216·48	258·68	99·10	54·84	131·20	161·62	1,738·86
1971	119·04	56·62	215·48	486·92	106·88	226·32	268·48	337·34	78·88	67·82	238·88	218·72	2,402·48
1972	117·72	68·20	240·34	486·56	141·52	177·52	189·16	344·00	61·56	78·14	303·66	250·34	2,427·48
1973	133·46	80·78	366·96	668·38	156·40	240·56	189·48	384·78	73·18	238·42	418·44	381·30	3,228·12
1974	94·87	110·18	481·38	798·07	294·07	364·38	302·80	522·38	140·17	137·97	589·73	379·00	4,163·21
1975	113·28	184·42	738·86	838·81	217·31	302·22	288·62	818·88	143·17	128·02	783·66	438·14	4,881·76
1976	88·80	136·36	813·18	824·01	298·66	314·80	288·80	630·66	178·66	200·62	983·63	567·36	5,314·40
1977	106·38	148·42	1,087·90	1,225·88	341·72	348·63	338·01	838·88	288·31	418·68	1,388·98	732·42	7,228·23
1978	16·79	181·76	1,480·33	1,847·43	488·46	387·84	808·43	888·43	388·00	338·00	1,881·06	840·06	8,373·77
1979	20·86	206·96	1,798·98	2,124·88	720·28	488·12	486·67	1,088·06	473·96	888·41	1,888·57	888·71	10,637·83
1980	11·64	337·42	2,047·23	2,568·80	724·48	480·41	647·66	1,247·74	584·63	325·77	2,536·50	727·20	12,228·48
1981													
March	5.98	278.19	2,127.09	2,808.16	758.47	510.10	668.24	1,281.51	612.56	220.62	2,458.56	828.26	12,328.72
June	9.55	224.32	2,071.98	2,874.96	733.18	563.86	658.54	1,253.80	620.37	303.38	2,480.82	776.72	12,381.25
September	9.29	248.98	2,008.32	2,753.88	727.07	634.38	688.47	1,228.71	651.06	250.44	2,348.87	783.56	12,356.49
December	8.98	333.03	2,211.63	3,186.80	678.10	584.66	562.84	1,408.17	686.93	236.88	2,370.14	916.08	13,183.82
1982													
January	14·29	364·24	2,294·62	3,158·81	879·78	633·67	588·14	1,480·77	688·88	273·53	2,448·82	922·58	13,884·33
February	44·52	298·54	2,164·66	3,030·57	860·14	687·81	620·08	1,510·06	736·17	380·14	2,434·19	880·88	13,818·86
March	11·20	288·08	2,241·50	3,012·88	922·62	679·67	628·87	1,586·27	686·32	362·37	2,371·22	838·56	13,870·33
April	9·36	374·43	2,164·61	3,338·87	867·86	688·63	644·72	1,579·48	682·48	314·81	2,508·73	788·03	13,808·20
May	9·14	364·08	2,134·46	3,316·20	836·46	687·42	679·57	1,479·07	644·68	478·23	2,562·30	732·16	13,881·64
June	12·39	404·98	2,348·14	3,470·61	822·97	627·12	673·68	1,544·81	641·66	574·18	2,308·74	823·57	14,260·87
July	15·66	368·17	2,294·32	3,397·78	808·37	647·48	688·18	1,511·86	617·52	381·11	2,688·47	753·16	14,080·14
August	16·13	368·56	2,308·80	3,466·04	830·78	771·86	688·98	1,531·36	640·80	312·84	2,671·48	788·07	14,256·80
September	14·08	348·56	2,417·88	3,394·31	842·08	808·07	670·41	1,434·57	608·10	312·38	2,748·06	811·11	14,218·58
October	18·17	388·42	2,388·91	3,418·32	838·61	634·30	668·78	1,447·10	627·84	332·14	2,674·80	780·30	14,178·37
November	16·92	365·23	2,374·53	3,388·02	813·46	584·94	688·78	1,466·48	637·97	573·14	2,844·23	811·76	14,384·41
December	20·13	640·04	2,257·84	3,501·43	868·04	617·06	707·64	1,488·82	660·20	568·29	2,678·11	888·90	14,832·58
1983													
January	17·24	584·04	2,230·98	3,434·08	820·03	571·86	671·46	1,588·48	622·41	711·86	2,738·33	886·56	14,888·02
February	20·63	619·46	2,298·13	3,374·00	830·67	618·52	643·06	1,514·33	634·88	771·80	2,738·19	834·62	14,788·01
March	17·57	724·34	2,525·90	3,418·78	881·56	640·42	652·62	1,571·64	631·42	548·17	2,728·02	728·38	15,040·88
April	16·84	747·66	2,866·24	3,411·28	860·04	628·40	684·68	1,584·78	474·49	487·28	2,814·14	794·40	15,129·06
May	17·17	841·96	2,671·31	3,376·03	888·66	710·83	676·47	1,510·82	479·33	474·94	2,083·47	746·48	15,058·50
June	15·94	884·10	2,773·62	3,419·11	911·72	724·68	720·78	1,588·14	529·04	480·14	2,686·16	728·32	15,388·86
July	15·80	1,031·98	2,878·35	3,473·48	867·43	778·46	867·13	1,688·67	508·58	373·86	2,702·84	738·14	15,340·03
August	16·08	930·48	2,568·41	3,438·34	843·38	808·68	673·21	1,588·28	534·84	424·01	2,738·66	740·86	15,084·33
September	16·98	1,008·24	2,888·13	3,866·48	848·37	788·00	684·70	1,848·30	580·10	828·47	2,847·48	770·88	15,885·43
October	16·88	984·58	2,713·84	3,518·58	881·84	733·63	683·81	1,878·08	530·40	523·18	2,880·74	780·62	15,510·88
November	10·87	1,111·24	2,862·60	3,588·63	827·78	738·18	848·22	1,848·52	544·46	880·16	2,811·68	833·38	15,888·82
December	16·03	1,138·08	2,788·82	3,542·17	848·27	753·40	812·20	1,818·33	638·31	1,078·40	2,883·63	828·01	16,234·88
1984													
January	86·82	1,088·11	2,748·12	3,482·86	841·08	751·84	688·81	1,730·28	803·81	848·26	2,877·66	787·48	16,048·21
February	16·76	1,481·82	2,562·34	3,429·41	903·68	792·42	603·11	1,722·12	529·16	1,088·48	2,822·68	748·71	16,467·80
March	17·12	1,441·78	2,565·58	3,688·17	884·08	750·78	714·88	1,722·82	800·08	911·84	2,513·68	728·43	16,434·02
April	16·91	1,434·66	2,421·43	3,787·31	837·40	781·68	881·18	1,704·06	484·00	880·38	2,879·61	737·80	16,848·88
May	16·82	1,486·11	2,482·57	3,688·78	888·38	817·82	688·80	1,828·79	808·50	1,118·28	2,722·11	683·81	16,843·42
June	19·82	1,481·73	2,488·84	3,880·81	846·48	823·67	714·48	1,822·81	853·83	836·88	2,728·07	724·18	16,801·66
July	16·78	1,482·48	2,804·17	3,878·23	883·13	888·32	738·64	1,878·72	888·56	828·88	2,808·64	704·88	16,714·88
August	17·78	1,473·11	2,580·47	3,884·68	1,010·68	882·80	708·72	2,088·38	848·16	821·06	2,822·32	710·65	17,008·84
September	17·70	1,407·34	2,516·87	3,718·04	988·66	1,107·04	708·76	1,868·27	881·88	479·72	2,887·20	722·88	17,281·48
October	28·56	1,563·24	2,480·33	3,813·74	947·88	888·38	717·42	2,284·28	817·08	823·67	2,873·17	781·28	17,380·30
November	17·84	1,466·88	2,848·87	3,828·88	1,002·02	880·28	847·88	2,272·70	821·06	882·06	2,822·28	768·18	17,828·88
December	17·84	1,828·02	2,729·44	3,808·76	1,038·08	880·88	782·44	2,382·43	848·96	832·88	3,034·08	728·82	18,188·88
1985													
January	14·08	1,460·28	2,878·80	3,888·46	1,108·96	918·18	837·42	2,427·28	878·88	841·84	2,867·38	781·80	18,188·78
February	14·23	1,428·81	2,888·74	3,788·86	1,123·14	1,008·02	844·32	2,531·57	887·88	883·96	2,884·66	737·81	18,440·28
March	15·08	1,611·84	2,840·88	3,848·78	1,121·46	976·66	882·62	2,377·68	814·80	744·80	2,888·44	728·21	18,788·20
April	16·88	1,888·21	2,788·44	3,888·43	1,101·01	1,082·04	872·21	2,818·66	888·88	861·63	2,888·77	788·84	18,288·12
May	14·48	1,812·33	2,763·01	3,987·23	1,128·98	1,010·14	1,018·48	2,611·47	814·33	888·84	2,787·16	828·84	18,847·31
June	14·61	1,818·18	2,876·34	4,031·64	1,114·97	922·76	1,088·73	2,488·68	814·12	838·88	2,888·67	882·78	18,318·27
July	13·97	1,535·00	2,888·23	4,186·40	1,231·70	1,083·38	1,072·11	2,488·14	888·78	881·48	2,838·78	781·71	18,828·88
August	13·79	1,484·88	2,848·67	4,124·88	1,277·80	1,063·01	1,088·22	2,338·42	888·67	915·66	2,830·70	841·81	18,888·88
September	14·87	1,880·08	3,117·48	4,513·64	1,048·41	987·41	1,488·65	2,382·68	728·31	1,171·34	2,873·71	884·66	20,301·48
October	15·47	1,848·72	3,083·93	4,388·88	1,178·77	971·78	1,174·75	2,388·12	718·97	1,077·14	3,088·68	882·27	20,484·75
November	18·23	1,637·71	2,837·61	4,388·54	1,188·83	988·32	1,138·68	2,828·38	788·88	1,128·62	3,081·46	913·87	20,348·13
December	18·78	1,734·62	2,887·67	4,402·63	1,174·06	1,033·47	1,168·88	2,488·81	738·63	1,114·77	3,211·34	824·31	20,888·68
1986													
January	17.08	1,812.79	2,984.84	4,438.78	1,272.80	1,172.98	1,130.86	2,636.21	784.87	1,288.10	3,222.48	918.88	21,328.28
February	14.74	1,571.48	3,007.78	4,610.84	1,264.03	1,138.84	1,080.84	2,868.34	776.96	1,428.28	3,212.77	906.46	21,537.43
March	16.58	1,686.54	3,084.63	4,294.19	1,228.28	1,230.71	1,087.84	2,787.16	788.61	1,441.57	3,471.57	908.25	21,988.70
April	15.37	1,546.03	2,984.32	4,332.44	1,286.61	1,237.38	1,233.02	2,758.94	791.00	1,584.88	3,618.42	983.82	22,580.83
May	21.93	1,631.02	3,129.81	4,482.68	1,338.08	1170.76	1,268.27	2,784.00	817.28	1,617.06	3,525.28	1,043.18	22,843.50
June	20.59	1,749.38	3,097.41	4,439.86	1,297.48	1,186.34	1,190.22	2,794.83	848.66	1,036.52	3,827.04	1,083.87	22,861.94

* Includes Local Government. Also includes E.A. Community institutions up to 1977.
† The new series relates to private enterprises only. Public enterprises are included under Commercial Statutory Boards and other Public entities.
Source: Central Bank of Kenya.

COMMERCIAL BANKS—BILLS, LOANS AND ADVANCES, 1981—1985

K£million

	1981 Dec.	1982 Dec.	1983 Dec.	1984 Dec.	1985 Dec.
PUBLIC SECTOR—					
Central Government ..	0·02	0·11	—	0·02	0·05
Local Government ..	0·43	0·90	0·80	0·87	0·89
Enterprises, Parastatal bodies and other Public entities	16·65	27·00	56·90	76·30	86·73
Treasury Bills	76·07	114·19	92·74	144·04	109·81
TOTAL PUBLIC SECTOR	93·17	142·20	150·44	221·23	197·48
PRIVATE ENTERPRISES—					
Agriculture	110·59	112·89	138·49	136·47	148·39
Mining and Quarrying ..	10·39	.9·78	6·27	7·08	8·54
Manufacturing	159·33	175·07	177·11	180·34	220·14
Building and Construction	33·91	42·90	42·41	51·81	58·70
Transport, Storage and Communication ..	34·30	33·01	26·97	27·45	36·30
Trade:					
Exports	29·73	30·85	37·67	49·05	51·67
Imports	28·13	35·38	25·61	39·62	55·04
Domestic	70·46	74·85	80·92	118·12	124·54
Financial Institutions .	11·83	29·92	53·92	41·65	55·74
Other Business ..	108·11	124·03	123·43	144·62	152·03
TOTAL PRIVATE ENTERPRISES	596·78	668·68	712·80	796·21	911·09
PRIVATE HOUSEHOLDS— (including non-profit making institutions)	45·80	34·94	41·25	36·45	46·22
TOTAL BILLS, LOANS AND ADVANCES	735·75	845·82	904·49	1,053·89	1,154·79

Source: Central Bank of Kenya.

110

Assets and Liabilities of Non-Bank Financial Institutions, 1981—1985

K£million

	As at End of				1985			
	1981	1982	1983	1984	1st Qr.	2nd Qr.	3rd Qr.	4th Qr.
Liabilities:								
Deposits—								
Central and Local Government ..	27·47	32·22	28·95	25·64	27·26	27·09	26·70	26·92
Other Public Sector	85·94	138·82	136·90	161·17	165·02	173·29	166·61	155·04
Other Depositors	171·17	187·78	267·75	420·88	444·03	473·52	503·43	519·75
Other Liabilities	105·47	153·98	193·22	258·64	253·16	249·33	265·84	294·97
Total Liabilities	390·05	512·80	626·82	866·33	889·47	923·23	962·58	996·68
Assets:								
Cash and Banks	32·12	69·49	64·08	103·24	90·89	67·24	85·40	98·91
Other Financial Institutions ..	15·99	35·70	34·16	85·71	81·91	82·84	73·56	75·31
Associated Companies	40·41	12·09	4·84	15·61	4·99	11·64	19·42	10·38
Investments, Loans, Advances, etc.—								
Public Sector	22·94	34·93	93·37	97·63	140·10	150·80	136·81	141·18
Private Sector	260·44	335·51	398·92	516·18	526·48	559·87	592·99	614·52
Other Assets	18·15	25·08	31·45	47·96	45·10	50·84	54·40	56·38
Total Assets	390·05	512·80	626·82	866·33	889·47	923·23	962·58	996·68

Source: Central Bank of Kenya.

Principal Interest Rates, 1983—1985

Percentage

	31st December		
	1983	1984	1985
Central Bank of Kenya			
Discount Rate for Treasury Bills	15·00	12·50	14·14
Advances against Treasury Bills	14·50	12·00	12·00
Bills and Notes under Crop Finance Scheme:			
Discounts	13·75	11·25	11·25
Advances	14·00	11·50	11·50
Other Bills and Notes:			
Discounts	14·50	12·00	12·00
Advances	15·00	12·50	12·50
Kenya Commercial Banks			
Time Deposits:			
12 months (KSh. 250,000–1,000,000) ..	12·50	11·75–12·00	11·75–12·00
Savings Deposits	12·50	11·00	11·00
Loans and Advances (Maximum)*	15·00	14·00	14·00
Other Financial Institutions			
Kenya Post Office Savings Bank deposits ..	11·00	11·00	11·00
Agricultural Finance Corporation, Loans			
(a) Land Purchase	12·00	12·00	12·00
(b) Seasonal Crop Loan	14·00	14·00	14·00
(c) Other	13·00	13·00	13·00
Hire-Purchase Companies and Merchant Banks:			
Deposits (time)	14·00–16·50	13·00–14·50	13·00–14·50
Loans	20·00	19·00	19·00
Buildings Societies:			
Deposits	15·00–15·50	13·00–14·25	13·00–14·25
Loans	16·00	16·00	16·00

Source: Central Bank of Kenya.

*Loans and advances for less than 3 years.

TRENDS IN SELECTED REAL INTEREST RATES, 1981—1985

Percentage

	Year	Nominal Interest	Inflation Rate*	Real Interest**
1. Commercial bank savings depost ..	1981	10·0	12·6	−2·6
	1982	12·5	22·3	−9·8
	1983	12·5	14·5	−2·0
	1984	11·0	9·1	+1·9
	1985	11·0	10·7	+0·3
2. Commercial bank loans and advances (max)	1981	14·0	12·6	+1·4
	1982	16·0	22·3	−6·3
	1983	15·0	14·5	+0·5
	1984	14·0	9·1	+4·9
	1985	14·0	10·7	+3·3
3. POSB deposits	1981	10·0	12·6	−2·6
	1982	10·0	22·3	−12·3
	1983	11·0	14·5	−3·5
	1984	11·0	9·1	+1·9
	1985	11·0	10·7	+0·3
4. Building society loans (max) ..	1981	14·0	12·6	+1·4
	1982	16·0	22·3	−6·3
	1983	16·0	14·5	+1·5
	1984	16·0	9·1	+6·9
	1985	16·0	10·7	+5·3

*Taken from Table 4.11.
**Nominal interest rate minus inflation rate.

Source: Central Bank of Kenya

13

C. MALAWI

1. MACROECONOMIC SURVEY

a. General Background

At the time of independence the economic prospects for this landlocked country looked bleak. Imports exceeded exports of goods and nonfactor services by 25% of GDP. Domestic savings were negligible and national savings negative. Domestic investment, which amounted to 8% of GDP, was financed through inflows of foreign resources. Foreign inflows also financed about half of current government expenditures.

The economic policies of Malawi have been more export-oriented and with more market-controlled pricing than many of the countries in Sub-Saharan Africa, especially for agriculture. Private ownership, however, has not been promoted. The government controls a significant proportion of economic activities through several quasi-public holding companies, such as ADMARC (the Agricultural Development and Marketing Corporation), Press Holdings (a holding company for 18 manufacturing and service firms), and MDC (Malawi Development Corporation). The economy is characterized by interlocking directorships of many of the largest ventures which, in some cases, has interfered with prudent economic decisions.

Economic growth was impressive up to 1978. GDP grew by over 6.8% annually at constant prices from 1964 to 1972, and by 6.4% between 1973 to 1978. Total investment increased from less than 8% of GDP in 1964 to nearly 24% in 1977-78. At the same time, domestic savings rose from negative to over 11% of GDP in 1978. The government budget deficit was steadily reduced after independence until 1972-73 when foreign budgetary support ceased. In most years there was a net surplus on the current account. The share of agriculture fell markedly over the period, because of growth in other sectors. However, agriculture was the growth center for the economy and smallholders increased cash crop production. Agricultural exports grew rapidly, principally tobacco and tea and later sugar. The estate sector led in export production, although remained a small share (13.2%) of total agriculture. During the late 1970s, there was much questionable long-term investment in tobacco estates which later proved costly for commercial banks.

In the early 1980s, the economy suffered a series of external and natural shocks, including low export commodity prices. Export competitiveness was damaged when the shortest rail routes to the sea through Mozambique were closed, which added an estimated $50 million per year in freight costs and delayed exports. Drought of 1979 and 1980 forced the country to import maize. Real GDP (at constant 1980 prices) fell at an average annual rate of 9.7% between 1979 and 1982.

The deficit on current account had been averaging about 11% of GDP, but increased to 15% of GDP over the 1979-82 period. This led to a sharp reduction in imports. Long-term capital inflows and aid funds declined during the recession and Malawi was forced to increase foreign borrowing at commercial rates. External debt increased from approximately $550 million in 1979 (53% of GDP) to $775 million (67% of GDP) by late 1982. The debt service ratio doubled from a level in the range of 20% to near 40%, after debt relief. By the end of 1983 foreign exchange reserves were down to less than one month of imports.

While the primary causes of the recession were external, rigidities and structural problems in the economy hindered the ability to respond to difficult external conditions. Adjustment to changing relative prices was hampered by restrictive price controls and wage policies, and the government/parastatal sector was accumulating large budget deficits. The government's role in the economy and the number of parastatals had increased during the 1970s. The share of the public sector in total fixed capital formation rose from 54% in 1973 to 70% by 1979. The drain of government and official entities in domestic credit increased from 10% in 1970 to 44% by 1980, partly due to government involvement in several large construction projects.

In 1980 the GoM began to formulate a medium-term structural adjustment program, assisted by 3 World Bank Structural Adjustment Loans ($240 million) and an IMF Extended Fund Facility ($100 million). A period of recovery lasted from 1982 to 1985, during which real GDP grew at an average rate of 3.4% per annum at constant 1980 prices. The current account deficit fell to 7% of GDP by 1984 when stocks were exported after having accumulated during 1983 because of transport problems. The government budget deficit fell back to 8% of GDP in 1985 from a high of 16.5% in 1981. Development expenditures were cut drastically, from 18% of GDP in 1981 to 7.5% in 1985.

By 1985, GDP growth in 1985 was a moderate 3%, although a declining terms of trade and continued high transport costs pushed up the current account deficit. The budget deficit was 9.6% of GDP for FY 1984-86. The fiscal problems of ADMARC forced heavy borrowing from the government and the banking sector, which pushed the growth in domestic credit above the ceiling allowed in the IMF agreement. The IMF Extended Fund Arrangement was terminated in early 1986, and a shortage of foreign exchange has hurt production and increased inflation. Economic performance in the first half of 1987 has been poor.

b. <u>Key Issues</u>

Many of the problems of the Malawian economy in the last decade have been exacerbated or caused by external shocks. However, domestic policies made adjustment to those shocks more difficult. The exchange rate is still somewhat overvalued, as evidence from foreign exchange rationing. Trade has not been liberalized. Firms are still required to license exports and

115

there are quantitative import controls. The budget deficit is problematic. The expanding role of the government and quasi-public sectors in large-scale ventures made adjustment to the adverse economic shocks of the early 1980s difficult. ADMARC, in particular, has been slow to divest and unwilling to sell assets.

There was a slight shift in government policy in the late 1970s away from reliance on large-scale enterprises for growth and development toward a more balanced growth strategy. Small and medium enterprises received almost no support. The government started several lending and support services for small ventures in the early 1980s, e.g. INDEFUND, SEDOM, DEMATT, and MEDI. However, there is still a strong bias toward large-scale ventures, both residual and explicit. The past emphasis on large-scale ventures held by conglomerates and the small private sector outside the conglomerate network are going to make it difficult to find suitable buyers to privatize the ventures, even if subdivided.

2. FINANCIAL SECTOR

a. Introduction

Malawi has a very low M2 to GDP ratio compared to other eastern African countries. The ratio was only 0.05 in 1984, indicating a low degree of monetization. Quasi-money has been growing more rapidly than the narrow money supply in the last few years. This might indicate the use of more sophisticated monetary instruments, or a fall in the transactional demand for money due to an increase in interest rates.

The financial sector is small and has not been growing rapidly. From the national income accounts, the financial and professional services sector is just over 6% of GDP. That sector had grown at an average of 14.7% per annum over the period 1973-79, but the average growth rate fell to 3.5% from 1979-82, and remained at 3.5% during the recovery of 1982-85. The sector declined by 2.2% between 1985 and 1986. The money, capital, and financial markets are very thin.

There are two commercial banks in Malawi, the National Bank of Malawi and the Commercial Bank of Malawi, which dominate the financial sector. These are regulated and supervised by the Reserve Bank of Malawi. There is a Post Office Savings Bank and a New Building Society. There is a development finance company, the Industrial Development Bank (INDEBANK), which now has a subsidiary, INDEFUND. There are also several new public-sector financial bodies created, like INDEFUND, to support small enterprises, SEDOM, DEMATT. There are three new small nonbank financial institutions (NBFIs), and two large and several smaller multinational insurance companies. There are also three large conglomerates, the Press Group, MDC, and ADMARC that engage in some financing activities.

b. The Reserve Bank of Malawi (RBM)

The Reserve Bank of Malawi serves as a central bank, is responsible for monetary control, holds the national foreign exchange reserves, engages in foreign borrowing, and administers exchange and import controls. RBM lends to cover the government deficit, a function that is now constrained by IMF guidelines. At this time there is no market mechanism for the exchange and transfer of public shares and government funds. The commercial banks can buy and sell government paper to the Reserve Bank upon request.

The Reserve Bank regulates and supervises the two commercial banks, operates the bankers' clearing house, retains the statutory balances and overnight funds from commercial banks, and serves as lender of last resort to commercial banks. For example, RBM lent to the Commercial Bank of Malawi during the recession. The RBM does not accept deposits or make loans to the private sector and rarely to statutory bodies, but it has occasionally lent to ADMARC. The RBM also lends to Press Holdings, but this must be done through ADMARC.

The financial position of RBM deteriorated over the period 1980-82 with government and parastatal borrowing. The government then turned from the Reserve Bank to the commercial banks for financing, because of IMF concern that borrowing from the Reserve Bank expanded overall credit. Government borrowing from the Reserve Bank went from MK 282 million at the end of 1983, to MK 240 million in 1984, MK 298 million in 1985, and MK 387 by March 1986. Its foreign exchange position was also eroded by increased foreign debt and successive devaluations of the Malawi Kwacha. RBM now holds only two weeks of foreign exchange reserves.

c. Commercial Banks

There are presently only two commercial banks, the National Bank of Malawi and the Commercial Bank of Malawi Limited. The National Bank of Malawi controls about 75% of the deposit market and the Commercial Bank of Malawi has the remaining 25%.

The National Bank of Malawi was established by an Act of Parliament in 1970 and formed in 1971 by merging Barclays and Standard Bank. After the merger the Press Group controlled 47.4% of the shares, ADMARC 32.6%, with 10% each for Barclays and Standard. The Barclay share were later sold to Standard which now holds 20% of the equity. Senior management is provided by Standard Chartered Bank. The National Bank is a conventional limited liability corporation and subject to the regulations of the Banking Act.

For the first few years of operation the NBM pursued conservatives policies, lending largely on a seasonal overdraft basis. Bank policies changed in the latter half of the 1970s to accommodate the government policy of promoting Malawian control of estate agriculture, especially tobacco. The National Bank

117

undertook a program of term lending, as well as seasonal finance to the targeted estates and increased term lending to the Press and Spearhead Groups. These policies proved to be unprofitable.

The NBM experienced heavy loan losses during the recession of the early 1980s which depleted the capital base. It has returned to a cautious lending policy and most funds are invested in government bonds or loans to parastatals. NBM no longer does much private sector term lending because of high loan losses in the past and because the interest rate structure makes investing in long-term government bonds more attractive.

The NBM has not yielded a profit in recent years (GoM Special Studies 1986/1 p. 5). There are insufficient data available to determine whether the problem is high operating costs, an insufficient interest rate spread, or the overhang of non-performing loans. Demand deposits are not paid interest and charges are levied according to the volume of transactions and on intercity transactions within the country. Transaction fees and commissions for intercity transactions are significant and contribute to bank profitability. Banking costs are high because of the network of fixed and mobile branches, expatriate management contracts, and staff training costs. The interest rate spread seems to be moderate, but there is no way to calculate the average cost of funds from the data available.

The Commercial Bank of Malawi was formed in 1969 with the Banco Pinto da Soto Mayor of Portugal owning 60%, MDC 20%, and Press 20%. The Portuguese interest was sold to the Bank of America and Malawi parastatals in 1974. After 1975, the Press Group owned 40%, Bank of America 30%, MDC 20%, and ADMARC 10%. The Bank of America decided to liquidate its holdings and its management contract with CBM in the early 1980s. The shares were sold to the GoM. The equity interest of ADMARC was turned over to MDC in 1984 as part of the MDC restructuring. The bank is presently 30% owned by the GoM, 30% by the Press Group, and 40% by the MDC.

CBM was even more severely hurt by heavy loan losses during the recession of the early 1980s than NBM. CBM had a higher loan-to-deposit ratio than NBM. Loan losses were covered by borrowing from the Reserve Bank of Malawi. The financial condition improved somewhat when the GoM took over the nonperforming loans to the Press Group. Like NBM, CBM now pursues a conservative lending policy, with preference for lending to the government and parastatal bodies rather than the private sector.

The deposit and lending policies of commercial banks in Malawi follow the British model closely. Demand deposits are non interest-bearing and incur transaction charges. Savings accounts pay 10.75%. With inflation at over 15%, the real deposit rate is less than -4.25%. This is the same rate paid by the Post Office Savings Bank, but the interest from commercial banks is taxable. There are limitations on withdrawals without

penalty and savings deposits do not offer overdraft facilities. About 73% of the deposit base of the two commercial banks is in time and savings deposits. There is a premium over the usual time deposit rate for overnight, call, and fixed time deposits. The penalty for early withdrawal on time deposits is rarely enforced. About two-thirds of the deposit base of commercial banks is from the private sector, but this includes some of the large holding companies.

The two commercial banks hold most of the financial savings. The most recent estimates of comparable savings are from the end of 1983. At that time the commercial banks had K 154.3 million in time and savings deposits, the Post Office Savings Bank (POSB) had K 41.4 million in savings deposits, the New Building Society had K 15.5 million in fixed, investment and savings deposits, and savings and credit cooperatives had about K 1.0 million in share deposits. Therefore, the commercial banks held about 73% of the financial savings held in formal institutions.

Survey results on the choice of savings institutions by small and medium enterprises is described in a recent study by USAID (12/86, pp. 41 to 42). The survey notes that the primary determinants were miniminal withdrawal procedures; proximity of the facility; and security. For savers with commercial banks, the most important determinants were withdrawal procedures; security; number of branches; and higher rates of interest. The most important reason for saving with a credit union was access to credit.

Lending is done via a fluctuating overdraft facility on a checking account. Banks do not lend for seed capital and do not lend to new customers. Both commercial banks switched policies after suffering heavy loan losses in the early 1980s and no longer do term lending. Since then the banking system has returned to investing heavily in government paper and maintain very high liquidity with the Reserve Bank. For example, the combined liquidity ratio of the commercial banks was 49% at the end of 1985 and 42% as of March 1986. The minimum lending rate is 16%, and with inflation of over 15%, the real lending rate is very low. There is some flexibility in lending rates above the minimum and the average may be closer to 18%.

In March 1986, the commercial minimum overdraft rate was 16%. There are additional fees, such as arrangement fee of about 1% and commitment fees on undrawn balances of about 1% to 2% annually, as well as legal fees for documentation.

Most bank credit goes to subsidiaries of ADMARC, Press, and MDC. About 50% of lending is to agriculture; 6% to manufacturing; and 7% to wholesale/retail ventures. Much of the lending to agriculture is to government guaranteed crop financing facilities for ADMARC. With the loss of the maize export market and low tobacco prices in 1985 and 1986, ADMARC had to borrow from the government and the banking system to reimburse smallholders. The government also encourages the banks to lend to growers of

119

tobacco and maize at the minimum lending interest rate of 16%, but the banks rarely deviate from the rigid repayment schedules for agricultural borrowers. Lending to small and medium enterprises is rare.

There is very little unsecured lending. Lending is usually overcollateralized. Lending is usually secured with an all-assets floating charge debenture for facilities so that banks can seize control of the business assets if the value is threatened. Other creditors have limited protection under this type of collateral which makes it difficult for businesses to access other facilities, particularly for term lending. The all-asset floating charge debenture is frequently backed by specific mortgage of real property, stop orders on purchase agencies (including crop purchasing agencies), personal guarantees from directors, cession of insurance, inventory hypothecation, and exclusive banking arrangements. The legal system allows for continuing security even when the account moves into a credit position.

The government borrowed regularly from the Reserve Bank between 1980 and 1982. Under pressure from the IMF, the government switched in 1982 to borrowing from the commercial banks, since borrowing from the Reserve Bank expands overall credit. Government borrowing from the commercial banks increased from MK 25 million at the end of 1980 to MK 98 in September 1985. (The resulting increase in the budget deficit and the net domestic asset of the banking system led to the termination of the IMF Extended Financing Facility in early 1986.) In 1986, net credit to the government increased to 105% of broad money, from a level of 77% in 1984. Over the same period, gross credit to the private sector declined from 65% to 54%.

Very little information is available on the location of branches. Coverage in rural areas is reportedly limited to the regional centers.

Year	Branches	Agencies	Mobile Units
1967	10	29	54
1970	17	32	76
1985	27	29	106

c. Nonbank Financial Institutions

There a few new nonbank financial institutions in Malawi, but there is little information available about them. Most are privately owned, many by Malawians of Asian descent, and some by foreign interests. The Mercantile Credit Limited is privately owned. It accepts time deposits and finances hire purchase (installment lending), lease hire, and debt factoring. The institution also block discounts commercial trade debt with

recourse. These forms of financing do not require exchange control clearance in the case of foreign-controlled companies. The Leasing and Finance Company of Malawi Limited was only recently formed. It accepts deposits from the public and intends to use them for leasing of industrial assets. The Malawi Finance Co. Ltd. is also new and specializes in trade finance such as letters of credit and export debt factoring.

d. Regulation of Banks and NBFIs

The national banking system is regulated by the Ministry of Finance and the Central Bank. The commercial banks have capital adequacy requirements, interest rate restrictions with real interest rates now about zero, and reserve requirements of 30%. Commercial banks are prohibited from equity investments in most cases.

3. COMPLEMENTARY FINANCIAL INSTITUTIONS AND SYSTEMS

a. Development Finance Institutions

There are three specialized development finance institutions: INDEBANK makes large loans of over 200,000 usually denominated in foreign currency; INDEFUND makes medium loans of 30,000 to 200,000 in Malawian kwacha; and SEDOM makes small loans of less than 50,000 and provides technical assistance to borrowers.

The Investment and Development Bank of Malawi Ltd. (INDEBANK) is a multinational financial institution, formed in 1972, with shareholders from the United Kingdom (CDC), Netherlands (FMO), Germany (DEG), and Malawi (ADMARC). It was funded through a combination of equity share ownership, income notes, and various lines of credit. IFC joined in 1978 to increase capitalization. INDEBANK was originally patterned after the Commonwealth Development Corporation (CDC) of Great Britain to play the role of a development finance company. INDEBANK invests exclusively in new activities, normally with fully collateralized term lending, but occasionally with equity financing. INDEBANK does not receive any subsidy from the government but serves as an intermediary for other lines of funds such as the World Bank. INDEBANK does not take local time deposits and has only limited Malawi kwacha resources. INDEBANK is not subject to the interest rate restrictions imposed on commercial banks because it is fully leveraged abroad. Loans are almost always denominated in foreign currency and the borrower must assume full exchange rate risk. Lending declined during the recent recession because of successive devaluation of the Kwacha. Its excess and liquid resources, if any, are held in government bonds.

INDEBANK lends primarily to the industrial sector, but has made a few investments in primary agriculture. Like the commercial bank, INDEBANK has lent heavily to the subsidiaries of Press Holdings, MDC, and ADMARC. About 61% of the portfolio is in loans to the subsidiaries of these three conglomerates. In 1986, the loan portfolio of INDEBANK amounted to 2.5% of GDP.

INDEFUND, a subsidiary of INDEBANK, began operation in early 1982 to lend to small- and medium-size Malawian enterprises. Priority is given to production for exports or substitutes for imports, rather than to trading or service activities. However trade, service, tourism, agriculture, construction, as well as production services have been funded. The initial loan range of MK 20,000 to 100,000 has been increased to MK 30,000 to 150,000. The lending operation is still relatively small with only 68 clients, including 26 loans approved in 1985 for MK 1.8 million (more details on the portfolio are available in USAID, 12/86, p. 23).

INDEFUND charges 16.5% interest on loans, and lending is for 2 to 12 years with a maximum grace period of 4 years. Borrowers must self-finance at least 10% of the total costs of the project. Security is taken in the form of debentures, mortgages, bills of sale, or life insurance. Loan demand is reportedly strong because loans are denominated in Malawi Kwacha.

INDEFUND can take equity positions in projects, but this has not been done yet because of dependence on loan funds from donors. It is likely that INDEFUND will need to adjust its funding arrangement to meet its mandate to deliver small-scale loans (see USAID, 12/86, p. 91). INDEFUND, from the project reports available, seems to do an adequate job of project appraisal but may not do sufficient monitoring of on-going loans, especially those in arrears. Operating costs for INDEFUND are fairly high. Delivery costs for INDEFUND are K 0.44 for every K 1.00 of credit (USAID 12/86, p. 111).

SEDOM was formed by the Malawian government, with assistance from the EEC, in 1982. SEDOM is to promote small and medium-enterprises in manufacturing, e.g. food processing, maize meal production, tailoring, and textiles. To date, activities have been focused in the southern part of the country. SEDOM can lend up to K 50,000 at 16%. The institution can process mini-loans relatively quickly. As of August 1986, SEDOM had granted 1,610 loans valued at K 2.99 million, with about 42% of the clients in rural areas. The requirement for the initial commitment of self-financing from the client can be up to 20% of the total costs of the project. SEDOM, like INDEFUND, cannot lend to enterprises with non-Malawian partners. Operating costs of SEDOM have been very high at about K 0.67 for every K 1.00 in credit (USAID, 12/86, p. 111).

b. <u>Other Financial Institutions</u>

The Development of Malawian Traders' Trust (DEMATT) was established in 1978 to provide business advise and technical assistance to small retail and wholesale traders. Since 1982 DEMATT has had a creditworthiness scheme, but no details were available on the credit component. This experiment should be investigated further as a possible model because it is one of the few experiments with uncollateralized lending.

The Malawian Entrepreneurs Development Institute (MEDI) provides courses on business startups in manufacturing, retailing, and services. It operates a small seed capital fund of UNDP funds for graduates. Loans to graduates have been over MK 100,000. This experiment should also be investigated as a possible model for small-scale lending.

The Malawi Union of Savings and Credit Cooperatives Limited (MUSCCO) was registered as the national umbrella organization for savings and credit cooperative societies and credit unions in September 1980. Cooperative societies, including credit unions, are exempt from the Banking Act and subject to a separate supervision system. MUSCCO got an initial five-year grant from USAID and technical assistance from USAID and the US Peace Corps.

Savings and credit cooperatives, although growing, do not cover the whole country. At the end of 1985, there were 58 credit unions, with about 14,500 members. Total loans outstanding amounted to MK 989,755 and total shares amounted to MK 934,414. The credit and savings cooperatives are not attractive for savings, per se, but are seen as a means of getting access to credit. The dividend rate on shares is low compared with the interest rates paid by commercial banks. In 1985 the dividend rate was 5% compared to 10.75% paid on a savings deposit at a commercial bank. The dividend rate is constrained by the ceiling on lending rates. The Cooperative Societies Act prohibits payment of dividends if money is lent out at more than 10% per annum. The cooperatives primarily function by revolving loan funds among low earning members of a community. Loan funds also can be made available for ventures such as purchasing of maize mills or crop finance. This is almost the only sources of finance available to rural entrepreneurs without collateral and bank references.

The Post Office Savings Bank (POSB) is solely a depository institution and does not lend or permit overdrafts. The POSB has 113 branches and 51 agencies throughout the country and primarily attracts small deposits. The minimum deposit balance is smaller than for commercial banks. While the primary function of the POSB is to serve small savers in dispersed areas, it also attracts other depositors with tax-free interest earnings. The POSB accepts deposits up to MK 20,000 from individuals and MK 60,000 from corporations. Notice is required for corporate withdrawals. The tax-free interest rate is now 10.75%. The POSB deposit base has been climbing and is now about MK 61 million. The Post Office Savings Bank invests exclusively in government paper.

Building societies and savings and loans are exempt from the Banking Act and have their own act. While details of the regulation were not available, building societies must be subject to a reserve requirement which is covered by investing in government bonds. There seems to be only one large building society, the New Building Society, which started operations in

in urban areas (including the district capitals, communities of about 4,000). The rural areas have few options for financial institutions. There are 40 to 50 commercial bank branches in rural areas. Commercial banks are only represented in the major regional centers. They lend almost exclusively to the estate farmers. A majority of smallholders do not have access to any credit facilities, and there seems to be little supplier's credit available outside the kin and friendship network. Savings facilities are also limited. There is the POSB, some savings and credit cooperatives, and a few savings schemes operated by some of the older farmers' clubs. There is agricultural credit available to some "progressive" smallholders through the farmers' clubs of the National Rural Development Program.

Malawi is the only country in Sub-Sahara Africa without a separate agricultural finance institution. Credit in-kind is available under the National Rural Development Program. Almost all of the credit available through the Rural Development Program is from international donors, and reports note that the central administration and coordination has been weak. Some projects have excess unused credit funds, while other projects receive almost no outside funds. Access to the credit available under the National Rural Development Program has never gotten above 3% of farmers. Few women, who head an estimated 30% of subsistence households, are members of farm clubs and most do not have access to credit. In 1985/86, MK 19.96 million in seasonal credit was given in kind, granted at a 10% flat rate equivalent or 13.5% effective rate. Only MK 0.90 million in medium-term credit was available in 1985- 86. In 1986 the total would have been only MK 15 (US $9) per farmer (IFAD, 1986, p. viii). Repayment rates have been very high, usually about 97%. Collection procedures through the groups seem to be very rigorous.

There is little incentive for the formal financial institutions to become more involved in the smallholder economy because of the low income levels, inability to use land collateral, and national agricultural policies. The World Bank Social Indicators (June 1985) estimated that 85% of the rural population of Malawi is below the absolute poverty level. The unfavorable price policy of ADMARC in the past has undoubtedly constrained agricultural profitability and therefore rural liquidity and hindered the development of rural financial markets. In the past there was some rural liquidity provided from foreign remittances and growth in wage employment in the estate sector. No firm estimates of the magnitudes of these flows are available.

Informal or supplier' credits appear to be scarce. Government policy has been to allow only Malawians to engage in rural trading. This, in effect, forced Asian traders into urban centers after 1974. The remaining private distribution system is very thin and most private trading is on a very small scale. Although the government has recently adopted several measures to encourage the re-emergence of a private trading network, to date there seems to be little informal rural credit outside of the kin

125

March 1964. The GoM has an equity position in NBS, but not controlling interest. NBS has offices and agencies only in five primary cities. NBS provides interest-bearing savings and time deposits. There is a low minimum deposit requirement. However, there are restrictions on withdrawals. All loanable funds go for mortgages, usually for 15 years. It provides house mortgage finance for the corporate (public) sector and for individuals. Interest paid on NBS mortgages is tax deductible. Total assets were K 30.6 million by March 1986. NBS is reportedly well administered and has had very few repossessions.

There are several foreign based general insurance companies (e.g. Hogg Robinson, and Old Mutual of South Africa) in Malawi. There is also a domestic company, the National Insurance Company (NICO), which is controlled by the Press Group. The foreign companies remit their premium income and transfer funds back into Malawi only as needed to meet claims. Only two companies invest in Malawi, and investment is concentrated in short-term government paper and prime investment projects. Insurance company funds could be a source of broader financing if policies were changed. Like the commercial banks, the insurance companies invest heavily in government bonds. commercial mortgages. On occasion the life insurance and pension funds (INDETRUST) provide long-term secured loans for industrial and commercial buildings and for employee housing projects.

d. Money and Capital Markets

There is almost no money market, and capital markets are limited to a few instruments. Banks can buy and sell government paper to the Reserve Bank upon request, which guarantees the liquidity of these instruments. Treasury Bills, with three-month maturity, are tendered through banks on a discount basis. Government stocks have maturities of up to 15 years at interest rates up to 15%.

The Companies Act of Malawi permits public stock companies, but there are only a few such as Southern Bottlers, the manufacturer of soft drinks. The market is extremely thin and institutionally undeveloped. There is no formal trading market for shares and no stock exchange. Transactions are arranged through commercial banks and corporate law firms. The market is illiquid and there is a 3% stamp tax on transfer of securities. It is doubtful that the volume would justify the expense of an organized trading facility. The potential for developing an active securities market is limited because investment activities are now vested in relatively few hands. The market would be very illiquid and transaction costs would be high. Certain Malawi securities are quoted outside the country based on special external registers authorized by Exchange Control.

e. Rural Financial Markets

Malawi is one of the least urbanized countries in Sub-Saharan Africa. In 1977 it was estimated that 8% of the population lived

and friendship network.

f. Accounting

There are several locally operating accounting firms, e.g. Deloitte Haskins and Sells, Peat Marwick and Mitchell, Price Waterhouse, and Coopers and Lybrand. However, the quality of local CPA services is not known.

g. Taxes

There was too little information available to evaluate the effects of the tax system on financial sector development. Most interest from deposits must be taxable because one report mentions the deposits of POSB have the advantage of being tax free. Interest paid on NBS mortgages is tax deductible. The impact of other regulations should be investigated.

4. CONCLUSIONS

The undeveloped money market in Malawi means there is a limited scope for monetary policy. At this time there is no market mechanism for the exchange and transfer of government financial instruments. The commercial banks can buy and sell government paper to the Reserve Bank upon request. Undeveloped capital markets limits investment and financing opportunities in the economy. Because there is not an organized equity market the commercial banks, insurance companies, and pension funds channel liquid funds into government paper.

Financial markets are very thin with few participating institutions. There are only two commercial banks, both primarily owned by the three large parastatals. The main problems with the commercial banks are interrelated: (a) much credit goes to the government through holding government paper and direct deposits with the Reserve Bank; (b) heavy lending to the parastatal holding companies; and (c) insistence on excessive security in lending to other firms. The lending portfolio is also concentrated in the three large conglomerates and subsidiaries so financial institutions are very vulnerable to performance of the large conglomerates. It seems likely that the commercial banks have poor quality portfolios and this may partially explain the shift back to low-risk investment in government paper.

Since most private companies are undercapitalized, the practice of overcollateralized lending severely restricts access to commercial bank lending facilities. There is the additional problem that debentures are the preferred form of security, but debentures are only available for corporate entities. While there is a security instrument for noncorporate entities, commercial credits, this is rarely used. The pattern of credit distribution mirrors broader structural issues in the economy

with the dominant role of the quasi-public holding companies.

Efforts to increase the availability of credit to small- and medium-size Malawian entrepreneurs have met only with limited success. Because the bias pervades government policy, a change in credit policy or the banking system alone will not help much until the other problems in pricing, marketing, basic profitability, and barriers to new entry are solved. However, use of alternatives to the debenture security instrument would expand access to borrowing facilities. Also development of INDEFUND could expand access. At the present time SEDOM is dependent on subsidies and lending is expensive, but if there is excess demand for SEDOM funds this institution should be helped to cut costs.

Thin domestic financial markets hamper attempts to privatize parastatals. The investment community is very small with only a few international and domestic corporations besides the three large conglomerates. Given the concentration of capital and ownership in the economy, privatization is likely to increase concentration. If the existing private firms take over newly privatized firms, this will increase leverage and may reduce competitiveness. Other options in privatization need to be explored. Malawi needs technical assistance on the alternative forms of securities markets that could be set up in lieu of a full-fledged stock exchange. Also INDETRUST and the two large insurance companies may be a potential market for some of the subsidiaries.

Term-financing facilities are shallow. None of the documents reviewed the investment practices of pension funds. The insurance industry provides some term financing, but also channels much of the funding into government bonds. INDEBANK and INDEFUND are not depository institutions and face funding constraints. These organizations may want to explore the possibilities of introducing term liabilities to raise domestic funds.

The commercial banks need to diversify their away from their current narrow client pool, which is dominated by the complex relationship between the banks and the conglomerates. This will require encouraging demand from a different segment of the economy, presumably the segment that now turns exclusively to INDEFUND and SECOM for funds. Clearly, startup businesses in Malawi need more assistance than simple access to capital, a topic recently explored by USAID (USAID, 12/86).

The growth and emerging role of the nonbank financial institutions need to be documented and explored. These might be an alternative to the seemingly static banking system. Several new small NBFIs have been started and may be a viable alternative to commercial banks for trade and specialized finance. SEDOM, INDEFUND, and DEMATT can potentially expand credit services to new clients. The credit and training role of DEMATT may also be an interesting case study. Since lending will not be tied

127

directly to tangible collateral, this will be an interesting alternative to collateralized lending. SEDOM should also be studied if the organization attempts to move away again from lending solely debentures to using alternative collateral instruments, and if costs can be contained. The activities of the new Malawi Finance and Leasing Company have reportedly opened competition for time deposits. Also, it is clear that the regulations that keep the lending rate and therefore the deposit rate low for cooperatives need to be changed to reduce distortions in allocation.

There are few linkages between the general population and the formal financial sector except through savings facilities. Banks favor repeat customers and place heavy reliance on collateral to evaluate creditworthiness. The land tenure system is an obstacle for expanding secured commercial bank lending and represents a major problem for establishing rural financial institutions. No cases were cited where the banks channel loan funds through the farmers' clubs, but this might be one option for supplementing general rural liquidity. The better clubs could be weaned from government funds and those funds used to reach new clients.

Finally, the economy of Malawi needs some far-reaching structural adjustments, which may include divestiture of some of the units of the large holding companies, privatizing some of the functions of government, and reducing visible and invisible barriers to entry for new private-sector ventures.

Appendix C.1: Banking Regulations in Malawi

The national banking system is regulated by the Ministry of Finance. The Secretary of the Treasury is the registrar of banks and other financial institutions. There was no information available on the coordination of responsibilities between the Ministry of Finance and the Central Bank. Commercial Banks are regulated under the Banking Act (Cap. 44:01 of the Laws of Malawi). The Reserve Bank of Malawi, the Post Office Savings Bank, building societies, statutory corporations, and cooperative societies are exempt from the Banking Act. There are additional laws governing the Reserve Bank of Malawi and the building societies. For the purpose of regulation, a commercial bank is defined as an entity which accepts deposits of money and uses them for lending. Commercial banks can accept deposits that are withdrawable by check.

Capital Requirements. The Banking Act requires paid-up equity capital plus or minus unimpaired reserve funds for a commercial bank of at least MK 500,000 and MK 100,000 for other financial institutions. The amount of paid-up capital required has reportedly not changed since 1964.

Interest Rate Restrictions. The interest rate structure is set by the Reserve Bank. There is almost no freedom on deposit rates.

There is more flexibility to set lending rates within the specified range. Since 1980 interest rates have been adjusted five times. The adjustments in 1985 made the rate schedule more flexible and that adjustment made the real rate positive, albeit low. Greater differentials in deposit rates by maturity were allowed and banks were to be allowed to set the rates on large short-term deposits. The spread between deposit and lending rates was increased. The interest rate structure has been stable since 1985. Real lending rates were very low in 1986 and 1987. As of November 1986 the bank rate was 11%, the Treasury Bill rate 12.75%, and the lending rate was 16%.

Reserve Requirements. Under the Banking Act, commercial banks must maintain at least 30% of their maximum claims payable on demand or at a determinable future date in liquid assets. (Another source said the minimum liquidity requirement has been 30% since 1979.) The liquid asset requirement is 15% for other financial institutions. Liquid assets include Malawi currency, net balances with the Reserve Bank, Malawi Treasury Bills, local bills up to 90 days maturity, and eligible for discount by the Reserve Bank, securities backed by government of unlimited maturity, demand and call balances with banks in Malawi, and certain items in transit.

Credit Controls. The commercial banks are occasionally given guidelines by the Reserve Bank on the expansion of domestic credit.

Lending Restrictions. Financial institutions cannot lend on security of their own shares or give outstanding advances to officials or employees exceeding emoluments of one year. This restriction does not apply to advances to nonexecutive directors or to companies controlled by directors, officials, or employees.

Commercial banks need Ministerial consent before directly engaging in wholesale, retail, import, or export trade, or acquiring real property other than bank premises or staff housing, except where necessary to recover debts due. Commercial banks are prohibited from equity investments in most cases.

Lending to Multinationals. The Exchange Control of the Reserve Bank must give prior approval before the commercial banks can lend to foreign-controlled firms. This requirement applies to all local financing other than equity financing, leasing, debt factoring, confirming, and export invoice discounting. The lending ceiling is set in relation to the equity investment of the potential borrower depending on the category of enterprise, and exporters are given priority. However, firms may not be able to borrow up to the ceiling. Exchange Control authorities have reportedly discouraged lending to multinationals during periods of tight liquidity.

Reporting Requirements/Inspections. All financial institutions must submit monthly balance sheets to the Registrar, for gazetting, at each month-end. Audited accounts must be submitted within six months of the end of each financial year. After

gazetting, the balance sheets and audited accounts must be prominently displayed at all premises from which they operate. There is no stipulated deadline for the gazetting, and it runs up to a year in arrears. All financial institutions must provide additional information to the Registrar on request, and submit to inspection by the Reserve Bank.

Appendix C.2: Aid Programs in Malawi

IMF Programs. The IMF three-year Extended Fund Facility for SDR 81 million started in September 1983. The IMF program developed problems in mid-1986 when Malawi failed to meet performance criteria and was cancelled before the last drawing. The Fund has not announced a new program yet.

World Bank Financial Activities. There have been three World Bank structural adjustment loans since 1981. The first structural adjustment program (SAL I, 1981) combined short-term stabilization measures to moderate the growth of aggregate demand and longer-term structural adjustment measures to increase aggregate supply. The program covered four areas: the balance of payments, prices and income, management of resources, and institutional improvements. The stabilization program was funded under an IMF stand by arrangements that ran until 1983. The medium-term structural adjustment program got initial funding from the World Bank of $45 million SAL in June 1981 (more details are available in USAID 612-0227, p. 7).

The second structural adjustment program started in December 1983 with $55 million from the World Bank. An Extended Fund Facility had been approved by the IMF in September and started in December 1983 for $100 million. Goals of SAL II were to establish a sustainable balance of payments position within three years, return to higher growth rates, and lowering the inflation rate. The Malawi Kwacha was devalued by 12% in September 1983 and tied to a basket of currencies in January 1984, with a further devaluation of 3%. Because the schedule of drawings was interrupted in 1984 and 1985 the program was rescheduled and the total amount reduced to SDR 81 million.

A third SAL was to run from December 1985 until September 1987 for $114 with cofinancing from the US, Japan, and West Germany. SAL III was being processed at the time that the financial problems of ADMARC had become a major drain on the government budget and the banking system. The major donors have stressed reducing the size of ADMARC by divesting some functions and rationalize its role in the agricultural sector. For example, the government took over the strategic grain reserves and agreed to reduce the fertilizer subsidies. This phase was originally funded for over $100 million but because of the appreciation of the dollar against the yen and the Deutschemark, funding grew to $130 million. A supplementary credit for $40 million was granted on the third SAL in December 1986.

SAL IV is in the planning stage. The Government of Malawi is being encouraged to reduce the budget deficit, promote exports, which is taken to mean more credit for the estate sector, and reorganize the parastatal sector, especially ADMARC. Negotiations are currently stalled over issues of the government deficit: which is now 13% to 14%; the erosion of tax revenues; and cost overruns.

The World Bank has just approved a new medium-term Industrial and Agricultural Credit package for $7.8 million to be channeled through the two commercial banks and INDEBANK. The funds are to be used to help the estates to diversify. The package was approved December 1985, signed April 1986, and became effective June 1986. Funds have not been disbursed yet. In addition, an agricultural credit program has been appraised for the World Bank. The World Bank has undertaken a nine-month study on Industrial Finance to begin in September. The World Bank also plans to fund a study on informal credit markets.

BIBLIOGRAPHY

a. Books and Monographs

Ettema, Wim (1984), "Small-Scale Industry in Malawi." The Journal of Modern African Studies, Vol. 22, No. 3, 1984, pp. 487-510.

Ghai, Dharam and Samir Radwan (1983), "Growth and Inequality: Rural Development in Malawi, 1964-1978." in Ghai, Dharam and Samir Radwan (eds.) Agrarian Policies and Rural Poverty in Africa. Geneva: International Labour Office, 1983, pp. 71-128.

Government of Malawi (1986), Ministry of Finance and Department of Economic Planning and Development. "Report on ADMARC Reconstruction." Special Studies Document 1986/1, April 1986.

Gulhati, Ravi and Gautam Datta (1983), "Capital Accumulation in Eastern and Southern Africa." World Bank Staff Paper No. 562, 1983.

Hirschmann, David and Megan Vaughan (1986), Women Farmers of Malawi: Food Production in the Zomba District. Berkeley: Institute of International Studies, Institute of International Studies, University of California, 1984. (Reviewed by Edna G. Bay in The Journal of Developing Areas. Vol. 20, No. 3, April 1986, pp. 386-387.)

Reserve Bank of Malawi. Quarterly and Annual Financial Reviews.

Sowelem, R.A. (1967), Towards Financial Independence in a Developing Economy: An Analysis of the Monetary Experience of the Federation of Rhodesia and Nysaland, 1952-63. London: Allen & Unwin, 1967.

b. Project Reports and Documents

Africare. "Indigenous Private Enterprise Project." Submitted to USAID/Malawi, May 1983.

Economist Intelligence Unit. (EIU) Country Profile: Malawi. 1987.

Coopers & Lybrand Associates. "ADMARC Divestiture." undated.

IFAD (1986),"Malawi: Rural Credit and Farm Club Development." Report No. 0017-MW. April 1986.

Price Waterhouse (1986),"Malawi Business Reference Guide, Prepared for United States Agency for International Development." Oct. 1986.

USAID. "Malawi Union of Savings and Credit Co-op Development." 1982.

USAID. The Private Sector and the Economic Development of Malawi. AID Evaluation Special Study No. 11, March 1983.

USAID. "Rural Enterprises and Agro-Business Development Institutions Project Paper." (612-0214), 1984.

USAID. "Country Development Strategy Statement: FY 1986", April 1984.

USAID "Malawi Economic Policy Reform Program (MEPREP)" (612-0225), Sept. 1985.

USAID. "Parastatal Divestiture: Agricultural Development and Marketing Corporation: FY 1986 African Economic Policy Reform Program Grant." (612-0227), July, 1986.

USAID. "New Directions for Promoting Small- and Medium-Scale Enterprise Development in Malawi: Constraints and Prospects for Growth." Dec. 1986.

World Bank. "Malawi Economic Recovery: Resource and Policy Needs, An Economic Memorandum." Oct. 4, 1985.

133

THE WEFA GROUP

MALAWI

OCT 13, 1987

MACROECONOMIC VARIABLES

	80	81	82	83	84	85	86
GROSS DOMESTIC PRODUCT, MILL US$	1206.1	1218.9	1244.0	1292.3	1193.7	1214.6	1137.5
GDP PER CAPITA, US$	197.7	196.6	194.4	195.8	175.5	171.1	NA
EXPORTS, FOB, MILL US$	281.4	269.8	235.2	228.7	314.5	250.1	246.0
CURRENT ACCT. BAL., MILL US$	-206.7	-88.7	-72.7	NA	NA	NA	NA
TOTAL EXTERNAL DEBT, MILL US$	645.6	680.0	699.7	718.2	728.4	774.8	NA
CONSUMER INFLATION, 1980=100	100.0	111.8	122.8	139.4	167.3	184.9	204.6
US$/KWACHA, PERIOD AVERAGE	1.23	1.12	0.95	0.85	0.71	0.58	0.54
POPULATION, MILL.	6.1	6.2	6.4	6.6	6.8	7.1	NA

MONETARY SURVEY

	80	81	82	83	84	85	86
MONEY SUPPLY, M2, MILL. KWACHA	191.5	241.4	276.4	292.8	388.3	384.4	472.4
CONSUMER INFLATION, 1980=100	100.0	111.8	122.8	139.4	167.3	184.9	204.6
WHOLESALE PRICE INDEX,1980=100	NA	NA	NA	NA	NA	NA	NA
DISCOUNT RATE	10.0	10.0	10.0	10.0	10.0	11.0	11.0
COMMERCIAL PRIME RATE	NA	NA	NA	NA	NA	NA	NA
GOVT. BOND YIELD, MEDIUM TERM	NA	NA	NA	NA	NA	NA	NA
DEGREE OF MONETIZATION	0.2	0.2	0.2	0.2	0.2	0.2	0.2

135

MALAWI

CONSOLIDATED BALANCE SHEET OF
COMMERCIAL BANKS
MILLION KWACHA

ASSETS	80	81	82	83	84	85	86
RESERVES	17.6	30.9	34.4	33.4	91.6	96.4	189.7
FOREIGN ASSETS	5.7	6.5	9.0	13.7	9.5	13.0	10.4
CLAIMS ON GOVT.	25.3	24.7	24.7	27.9	86.7	97.9	97.5
CLAIMS ON PRIVATE SECTOR	184.2	192.0	219.1	254.7	228.8	212.7	236.3
LIABILITIES							
DEMAND DEPOSITS	61.5	73.9	80.4	71.6	87.7	97.5	107.7
TIME AND SAVINGS DEPOSITS	94.3	126.7	145.6	165.0	234.0	217.5	268.0
FOREIGN LIABILITIES	46.6	29.7	32.7	48.1	51.2	68.6	99.3
GOVT. DEPOSITS	NA	NA	NA	NA	NA	NA	NA
CREDIT FROM CENTRAL BANK	NA	NA	NA	NA	NA	NA	NA
CAPITAL ACCOUNTS	NA	NA	NA	NA	NA	NA	NA
VALUATION ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
OTHER ITEMS, NET	52.8	46.6	57.6	69.4	75.5	83.2	83.6

BALANCE SHEET OF CENTRAL BANK

ASSETS	80	81	82	83	84	85	86
FOREIGN ASSETS	56.5	44.5	24.9	20.0	92.4	76.9	42.2
CLAIMS ON GOVT.	67.3	152.2	223.7	282.2	240.0	297.7	383.7
CLAIMS ON OFFICIAL ENTITIES	34.5	39.3	36.4	40.1	50.6	63.5	72.2
CLAIMS ON COMM. BANKS	8.9	0.0	0.0	1.0	0.0	0.0	0.0
CLAIMS ON SPECIAL BANKS	NA	NA	NA	NA	NA	NA	NA
LIABILITIES							
RESERVE MONEY	53.3	71.8	84.8	89.6	158.1	166.0	286.4
OF WHICH							
CURRENCY OUTSIDE BANKS	35.3	39.4	49.5	50.0	56.9	66.0	79.3
QUASI-MONEY DEPOSITS	NA	NA	NA	NA	NA	NA	NA
FOREIGN LIABILITIES	96.2	141.0	169.8	204.8	195.2	263.7	331.8
CAPITAL ACCOUNTS	NA	NA	NA	NA	NA	NA	NA
RESCHEDULING ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
VALUATION ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
OTHER ITEMS, NET	17.3	22.5	3.5	4.2	-12.2	-44.4	-129.6

MALAWI

GOVERNMENT FINANCE
MILLION KWACHA

	80	81	82	83	84	85	86
DEFICIT(-)/SURPLUS(+)	-72.8	-113.3	-67.0	-125.3	-137.2	-114.1	NA
REVENUE	198.8	214.6	230.6	272.6	311.0	383.6	NA
EXPENDITURE	301.9	360.7	323.7	423.9	474.1	539.8	NA
FINANCING							
DOMESTIC	26.3	83.7	86.9	77.0	45.4	75.2	NA
FOREIGN	62.3	40.8	38.1	37.6	78.8	-11.1	NA

INTERNATIONAL DEBT
MILL. US$

	80	81	82	83	84	85	86
TOTAL EXTERNAL DEBT, (EDT)							
LONG-TERM DEBT	645.6	680.0	699.7	718.2	728.4	774.8	NA
PUBLIC AND PUBLICALLY GUARANTEED	645.6	680.0	699.7	718.2	728.4	774.8	NA
PRIVATE NONGUARANTEED	0.0	0.0	0.0	0.0	0.0	0.0	NA
USE OF IMF CREDIT	61.1	87.6	81.2	102.1	112.6	133.9	NA
SHORT-TERM	111.0	50.0	85.0	73.0	42.0	79.0	NA
TOTAL LONG-TERM DEBT							
DEBT OUTSTANDING AND DISBURSED	645.6	680.0	699.7	718.2	728.4	774.8	NA
DISBURSEMENTS	160.2	126.2	74.7	63.2	107.3	51.6	NA
PRINCIPAL REPAYMENTS	33.0	39.4	29.4	28.9	43.4	48.0	NA
NET FLOWS	127.2	86.8	45.3	34.3	63.9	3.6	NA
INTEREST PAYMENTS	34.6	49.3	32.7	29.8	30.8	27.9	NA
NET TRANSFERS	92.6	37.5	12.6	4.5	33.1	-24.3	NA
TOTAL DEBT SERVICE	67.6	88.7	62.1	58.7	74.2	75.9	NA
PRINCIPAL RATIOS							
TOTAL EXTERNAL DEBT							
EDT/XGS)	264.1	256.4	284.6	NA	NA	NA	NA
EDT/GNP)	71.1	71.1	78.2	77.2	77.7	96.5	NA
INTERNATIONAL RESERVES	75.9	54.1	28.5	20.3	60.5	49.1	NA

135

Monetary Survey
(MK mn)

	1980	1981	1982	1983	1984	1985	1986[a]
Foreign assets (net)	-81	-120	-169	-219	-145	-242	-371
Domestic credit	333	430	506	593	606	685	788
of which:							
claims on government	92	176	222	274	295	362	444
claims on official entities	57	62	65	65	83	110	112
claims on private sector	184	192	219	255	229	213	232
Money	97	115	131	128	154	167	205
Quasi-money	94	127	146	165	234	218	274
Restricted deposits	...	...	...	8	10	20	15
Other items (net)	61	69	61	73	63	39	-76

a November.

Trend of Trade
(MK mn for exports, imports, trade balance; indices 1980=100)

	1981	1982	1983	1984	1985	1986
Exports (incl re-exports)	243.9	253.0	270.6	446.2	429.7	451.6
Imports (cif)	313.4	323.0	363.8	381.6	492.6	478.7
Balance	-69.5	-69.9	-93.1	64.7	-62.8	-27.1
Volume of exports[a]	79.3	82.4	109.2	79.4	94.8	102.9
Volume of imports	83.9	80.0	80.4	64.1	81.3	65.4
Commodity terms of trade	121.6	123.4	113.3	118.1	100.8	93.3
Income terms of trade	96.5	101.7	123.7	93.7	95.6	96.0

a Domestic exports only.

Source: Economic Report 1987. Reserve Bank of Malawi

Principal Interest Rates
31st March, 1986

	Effective from	%
Bank Rate	15/4/1985	11.00
Treasury Bills (91 days)	15/4/1985	12.75
COMMERCIAL BANKS:—		
Savings Deposits	15/4/1985	10.75
Short Term Deposits:		
(K10,000 or over subject to 30 days' notice of withdrawal, maximum K1,000,000)	21/3/1980	11.50
Time Deposits		
3 months to 5 months	15/4/1985	12.75
6 months to 11 months	15/4/1985	13.25
12 months to 23 months	15/4/1985	14.25
24 months to 35 months	15/4/1985	14.75
36 months and over	15/4/1985	15.75
Bank Overdraft		
Minimum Rate	15/4/1985	16.00
Discount Rate (first class bills)		
Up to 120 days	15/4/1985	16.00
Exceeding 120 days	15/4/1985	19.00
BUILDING SOCIETY:—		
Fixed deposits		
(Deposits accepted between K10—K100,000)		
6 months to 11 months	1/6/1983	13.25
12 months to 24 months	15/4/85	14.25
Savings Deposits		
Up to K200 on demand in any one day	1/6/1983	10.75
Over K200 — by arrangement	1/6/1983	10.75
Investments Deposits		
Up to K1,000 — 2 months' notice	1/6/1983	12.75
K1,001 — K2,000 — 4 months' notice	1/6/1983	12.75
Over K2,000 — 6 months' notice	1/6/1983	12.75
Minimum Mortgage Rates		
Housing for owner occupation	1/6/1983	13.75
Flats and rented houses	1/6/1983	16.25
Commercial properties	1/6/1983	17.75
POST OFFICE SAVINGS BANK	1/6/1983	10.75

Source: Reserve Bank of Malawi.

MALAWI: INTEREST RATES, 1974-84
(In Percent; End of Period)

	1974	1976	1978	1979	1980	1981	1982	1983	1984
Bank Rate	6.0	7.0	7.0	8.0	10.0	10.0	10.0	10.0	10.0
Treasury Bill (91 Days)	5.6	6.0	6.0	7.25	9.0	9.0	9.0	11.0	11.0
Commercial Banks									
Lending	8.5-13.00	10.0-15.00	10.0-15.00	11.5-16.50	13.5-18.5	13.5-18.5	13.5-13.5	13.5-16.5	13.5-16.5
Deposits									
Savings 1/	4.00	5.50	5.50	6.75	8.75	8.75	8.75	10.75	10.75
Short-term	4.25	6.25	6.25	7.50	9.50	9.50	9.50	11.50	11.50
Time Deposits									
3-5 Months	4.50	6.50	6.50	7.75	9.75	9.75	9.75	11.75	11.75
6-11 Months	5.00	7.00	7.00	8.75	10.25	10.25	10.25	12.25	12.25
12-23 Months	5.00	7.50	7.50	8.75	10.75	10.75	10.75	12.75	12.75
24-35 Months	5.00	7.50	8.00	9.25	11.25	11.25	11.25	13.25	13.25
Over 35 Months	6.50	7.50	8.50	9.75	11.75	11.75	11.75	13.75	13.75
Other Institutions									
Post Office Savings Bank Deposits	5.00	5.00	5.50	6.75	8.75	8.75	8.75	10.75	10.75
New Building Society									
Fixed Deposits									
6-11 Months	5.00	7.00	7.00	8.25	10.25	10.25	10.25	12.25	12.25
12-23 Months	5.50	7.50	7.50	8.75	10.75	10.75	10.75	12.75	12.75
24-35 Months	6.00	8.00	8.00	9.25	11.25	11.25	11.25	13.25	13.25
Over 35 Months	7.00	8.50	8.50	9.75	11.75	11.75	11.75	13.75	13.75
Savings Deposits	4.00	5.00	5.50	6.75	8.75	8.75	8.75	10.75	10.75
Investment Deposits	6.00	7.00	7.50	8.75	10.75	10.75	10.75	12.75	12.75
Minimum Mortgage Rate	8.0-10.50	8.0-10.50	8.5-12.50	9.75-13.75	11.75-15.75	11.75-15.75	11.75-15.75	13.75-17.75	13.75-17.75

1/ MK10,000 or over subject to 30 days' notice of withdrawal; maximum MK1,000,000.
Source: Reserve Bank of Malawi, Financial and Economic Review

Commercial Banks: Advances[1] by Main Sectors
(K'000)

Year	Agriculture, Forestry and Fishing	Manufacturing	Construction	Wholesale and Retail Trade	Financial Institutions	Private Accounts	Services[2]	Others[3]	Total[4]
1965	1,446	2,868	68	2,448	14	326	372	613	8,153
1966	1,196	3,018	38	3,236	170	346	352	522	8,878
1967	1,552	2,662	120	3,610	836	496	496	598	10,370
1968	1,842	3,028	254	3,740	1,540	772	726	688	12,590
1969	1,874	4,316	1,392	5,686	1,100	1,156	454	842	16,820
1970	2,086	4,526	2,034	7,406	1,922	1,400	1,146	1,118	21,638
1971	3,015	4,834	1,354	10,537	1,980	1,569	2,694	1,573	27,556
1972	3,306	5,617	821	12,633	3,212	1,237	3,402	2,727	32,955

Year Month[5]	Agriculture	Mining and Quarrying	Manufacturing	Electricity, Water and Gas	Construction and Civil Engineering	Wholesale and Retail Trade	Transport, Storage and Communications	Finance, Insurance, Real Estate and Business Services	Community, Social and Personal Services	Personal Accounts	Total[4]
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
1973	5,705	2	2,308	—	804	13,284	444	5,205	292	1,139	29,183
1974	7,763	8	3,976	—	1,445	26,229	597	3,698	1,315	1,687	46,698
1975	13,606	—	6,059	1	480	25,013	1,319	3,338	2,009	3,402	55,227
1976	27,872	5	7,652	—	1,762	21,328	2,486	4,972	2,392	3,273	71,742
1977	30,190	15	12,675	56	570	29,980	2,290	7,373	713	2,484	86,346
1978	53,763	13	13,552	73	2,812	25,193	3,096	14,512	2,135	5,703	120,852
1979	81,853	147	9,667	2	3,653	36,752	3,549	24,323	5,987	4,672	170,606
1980	92,671	386	6,689	8	1,483	16,548	4,014	35,543	9,705	5,198	172,245
1981	94,272	330	6,053	3	1,328	20,387	6,807	39,683	13,914	7,012	189,789
1982	115,128	181	7,819	134	1,266	19,723	3,373	45,792	22,448	6,250	222,114
1983	138,520	345	10,838	64	853	30,684	8,502	55,159	15,847	3,271	264,083
1980 Mar.	92,595	222	8,643	5	1,383	22,640	3,418	31,649	7,827	3,705	172,287
Jun.	87,962	164	9,193	4	2,261	20,204	3,753	40,738	1,472	4,984	170,735
Sep.	77,712	178	6,682	4	1,841	19,408	3,902	40,671	1,743	5,119	157,260
Dec.	92,671	386	6,689	8	1,483	16,548	4,014	35,543	9,705	5,198	172,245
1981 Mar.	98,520	870	6,188	4	2,464	15,277	3,115	36,793	9,951	6,104	179,276
Jun.	93,347	375	7,028	3	1,006	18,900	3,416	39,665	3,085	7,300	174,125
Sep.	87,287	153	4,957	4	1,001	15,567	3,819	37,258	12,389	6,445	168,860
Dec.	94,272	330	6,053	3	1,328	20,387	6,807	39,683	13,914	7,012	189,789
1982 Mar.	108,720	15	9,073	2	955	21,447	3,830	41,250	18,409	7,845	211,546
Jun.	99,675	212	4,778	2	1,363	41,126	3,691	43,719	20,266	6,746	221,578
Sep.	111,837	174	7,111	157	1,134	34,383	4,523	42,951	21,655	3,418	229,343
Dec.	115,128	181	7,819	134	1,266	19,723	3,373	45,792	22,448	6,250	222,114
1983 Mar.	124,414	187	8,855	17	810	19,621	2,603	45,102	24,891	4,673	231,173
Jun.	125,201	193	7,384	295	1,344	39,753	2,235	49,311	14,208	14,812	254,736
Sep.	120,219	202	14,369	63	1,001	28,109	2,155	54,345	26,628	3,176	250,267
Dec.	138,520	345	10,839	64	853	30,684	8,502	55,159	15,847	3,271	264,084
1984 Mar.	141,408	8	17,257	4	917	19,770	6,354	58,155	28,140	6,173	278,184
Jun.	..	..	.								
Sep.	..	..	.								
Dec.	..	..	..								
1985 Mar.	..	..	.								
Jun.	..	..	.								
Sep.	..	..	..								
Dec.	..	..	..								
1986 Mar.	..	..									

Source: Data provided by commercial banks to the Reserve Bank of Malawi

[1] Figures in this table do not agree with figures in Table 1.3.2 up to December, 1976 because they relate to the second Wednesday of the month. However, from March 1977, the figures are as at the end of the months.

[2] Includes the professions, non-profit and charitable organisations and entertainment

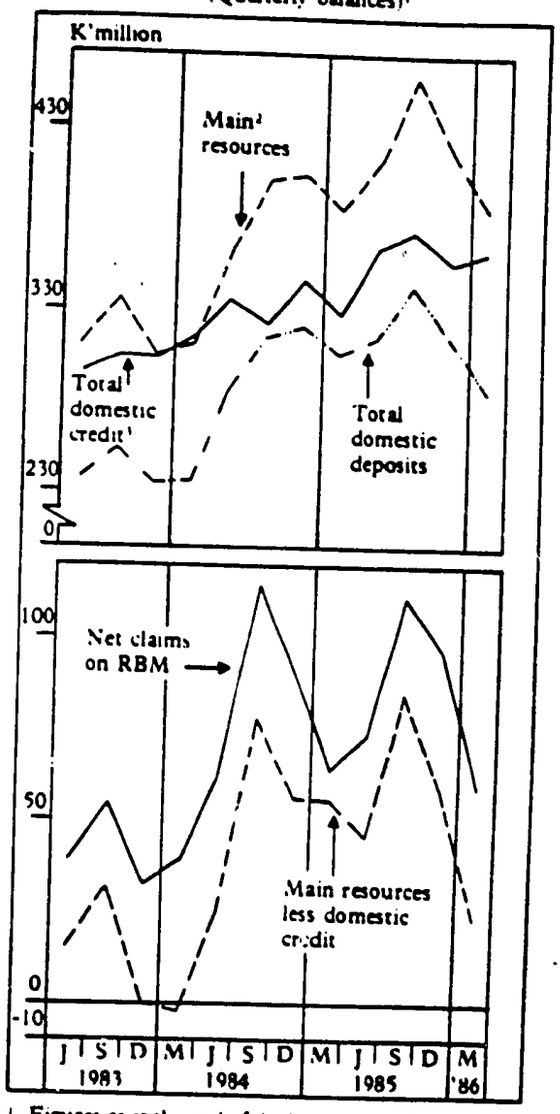
[3] Includes mining, transport and communications and non-residents

[4] Excluding statutory bodies and local authorities

[5] See Introduction to Statistical Annex of Vol. V Number 3, 1973 of the *Review*.

140

Commercial banks:
Principal resources and their uses
(Quarterly balances)[1]

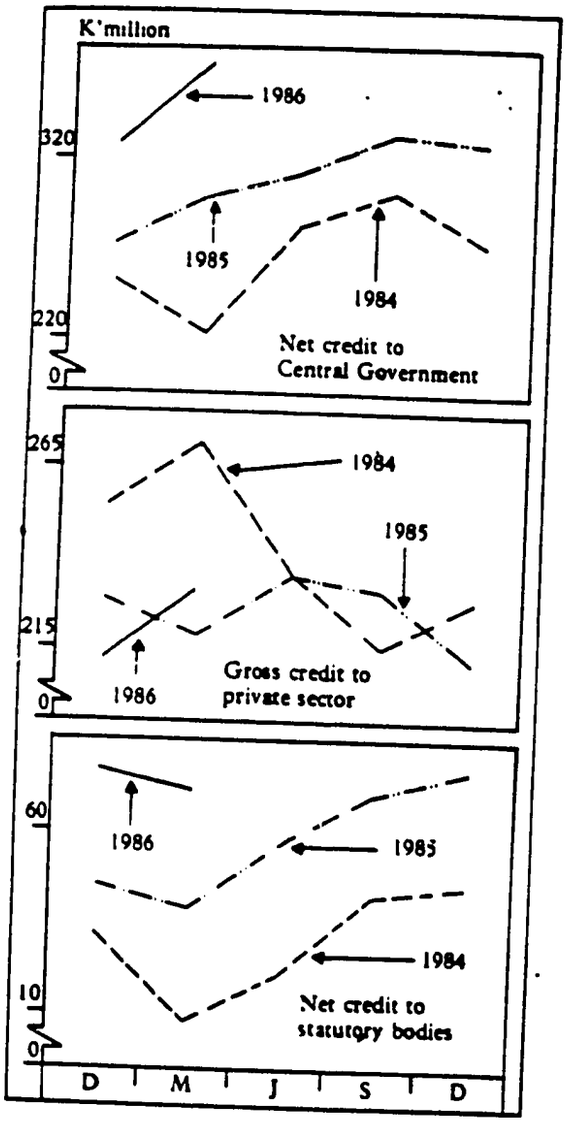


[1] Figures as at the end of the last month of the quarter.
[2] Deposits, net foreign liabilities and capital accounts.
[3] Credit to the Central Government, statutory bodies and private sector.

Source: Reserve Bank of Malawi

141

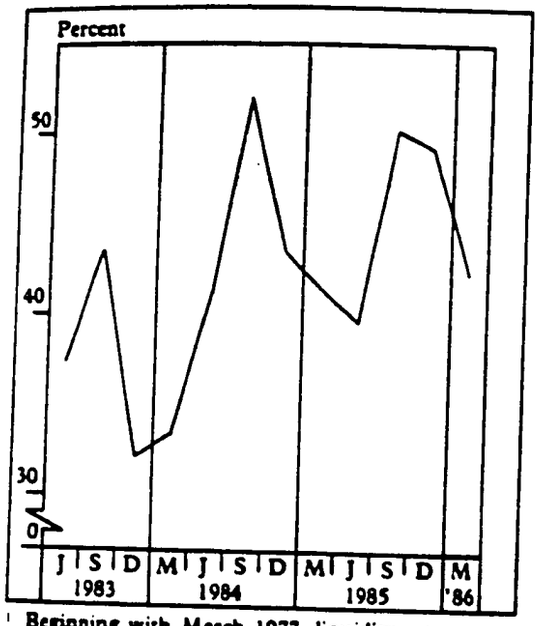
Banking system: Net credit to official sector and gross credit to private sector (Quarterly balances)[1]



[1] Figures as at the end of the last month of the quarter. The first entries refer to the last quarter of the preceding year.

Source: Reserve Bank of Malawi

Commercial banks:
Liquidity ratios[1]
(Quarterly)[2]



[1] Beginning with March 1977, liquidity ratios are computed on the basis of the new definition (see Statistical Annex Table 1.7.2).

[2] Figures as at the end of the last month of the quarter.

Source: Reserve Bank of Malawi

143

D. MALI

1. MACROECONOMIC SURVEY

a. Introduction and Discussion of Key Problems

Mali is one of the larger landlocked countries in West Africa, having a total area of 1,241,000 sq. km. By any standard, it is a vastly underdeveloped country, suffering from the typical problems besetting poor countries. It is estimated that, in 1980, fully 25% of city-dwellers and 40% of the rural population earned incomes below the subsistence level. Infant mortality averages 48% of all children under 1 year, life expectancy is 45 years for men and 47 years for women. Some 80% of the rural population is illiterate.

In addition to the above-mentioned grave short-comings in the quality of life, there are basic economic problems with which Mali must contend. These include:

- A growing population (2.5% annually on average in recent years, compared with 1.3% annual average GDP growth), characterized by considerable migration, heavy geographic imbalance (80% concentrated in the rural sector), and poor health conditions.
- A climate that varies considerably between the North and South of the country.
- Natural resources that are little or poorly exploited (notably in agriculture).
- Relative isolation of the country. To the north is the Sahara; the only access is toward the west, namely the rail line (a very difficult route) toward Sikasso and on to the Ivory Coast.
- Difficult transportation within the country; in some areas, the River Niger provides the only real link with the rest of the country.

On the whole recent economic performance has been disappointing, especially in the 1980s. As mentioned above, GDP has grown little relative to the population, resulting in a decline in per capita income. Also, as a result of the severe drought experience in 1983-84, real GDP declined a cumulative 4.2% in that period, followed by a real decline in 1985 of 1.7%, a reflection primarily of a drop in traditional agricultural production by 14.5%. In addition, the structural imbalance in the economy shows no sign of being remedied. Currently, the evolution of the economy's structure has proceeded as follows:

- The primary sector (agriculture, fishing, and forestry) accounted for 50% of GDP in 1984. Over the period 1981/1985, this sector's share of GDP has declined in relative and absolute terms.
- The tertiary sector (transportation, commerce, and other services) accounted for 37% of GDP in 1985), and its share of GDP

has grown over the period 1981/85 in relative and absolute terms.
- The secondary sector (industry) accounted for no more than 13% of GDP in 1985, and its share of GDP has remained grown little in relative and absolute terms over the period 1981/85.

In effect, therefore, the economy is characterized by severe sectoral imbalance. In particular, there is heavy dependence on the agricultural sector (which puts the economy at the mercy of the elements and of world crop prices) and, while the agricultural sector has diminished somewhat in importance in recent years, this has actually had adverse implications for the economy, as the service sector, which comprises much non productive activity and has limited potential for generating exports, has grown at the expense of agriculture. The potential for developing a viable industrial sector, which could serve to propel the economy on a growth path, is very limited given:

- The shortage of capital
- The need for far-reaching restructuring of the secondary sector, which is dominated by state-owned enterprises
- The current uncertainty surrounding the country's overall prospects, which is discouraging private sector investment, domestic and foreign.

Imbalances in the fiscal and external sectors continue to pose serious problems for the economy. The persistence of budget and trade deficits has resulted in high inflation, continuing economic instability and a mounting debt burden. The critical natural of the aforementioned problems by the mid-1980s necessitated the adoption of a number of measures in the interest of attaining stabilization. This includes a World Bank-sponsored public sector reform program, an IMF-prescribed structural adjustment program adopted in 1985, and an overhaul of monetary policy following Mali's admission to the UMOA in 1984.

Public finance poses a chronic problem, a reflection of the failure of the state and of financial institutions to mobilize resources. As far as government receipts are concerned, the emphasis has been on indirect levies, namely customs and excise taxes, rather than on income taxation. On the expenditure side, the need to rationalize public sector spending has become apparent. The financial health of public sector enterprises has been chronically poor, primarily because:

- The nature of the ties between the State and public sector enterprises remains vague, which results in major confusion that cannot but harm the management of public finances. The majority of public sector enterprises run substantial deficits, financed by heavy borrowing from the Banque de Developpement de Mali (BDM), the public sector bank.
- Delays in payments by the state have had a chain effect in delaying payments between the different public sector enterprises and to other sectors of the economy.
- Public sector enterprises have for a long time been employed by the government as a means to limit the growth of

115

unemployment, a factor which has resulted in the absorption of labor that could not be profitably utilized and made the financial prospects of these enterprises uncertain.

The World Bank has been putting pressure on the government to restructure the public sector, maintaining some enterprises, and privatizing or eliminating others. Reforms in this regard have, in fact, been adopted by the government, notably a series of organizational reforms and the liquidation of Air Mali undertaken in 1986. At the same time, implementing the full range of reforms presents serious problems, since:

- It is difficult to persuade private entities to acquire essentially bankrupt state enterprises.
- The psychological disposition and the lack of relevant training of public sector employees will complicate attempts to absorb them into the private sector.
- A number of senior employees are expected to resist a restructuring of their turf that could rob them of influence or threaten their income with diminution.

Despite the existence of rigid price controls until recently, inflation has been a chronic problem, caused in part by the need to monetize the public sector deficit, and in part by periodic crop failures. Inflation averaged 10.3% during the period 1973 to 1983. Although inflation fell to 6.8% in 1983, massive monetary growth caused it to accelerate further to 11.6% in 1984. In the early part of 1985, a prolonged drought, the enactment of price liberalization in the context of structural adjustment, and the conversion of Mali France into CFA Francs following Mali's admission into the UMOA resulted in a significant jump in inflation despite the persistence of price controls. Later that year, Mali adopted an IMF stabilization program. The program did result in lower prices; however, as its implementation was accompanied by a spurt of rainfall and the tardy arrival of food aid, much of the decline was due to the collapse of domestic grain prices, which had the unfortunate side effect of reducing income to farmers. On a year-end basis inflation averaged 6.7% in 1985. As credit expansion accelerated and many price controls were phased out in 1986, a high inflation rate persisted, estimated at 5.6%.

Another source of imbalance is the foreign sector. Mali's foreign trade is heavily dependent on climatic conditions and on fluctuations in the prices of agricultural commodities, particularly cotton. This has resulted in considerable fluctuations in exports and imports which have left the trade balance in serious deficit. The agricultural situation improved somewhat in 1986 as a result of improved rainfall, but the trade balance has remained in deficit (CFAF 39 billion) due to inadequate grain production, the decline in peanut output and the fall in cotton prices. At the same time lower service payments combined with the modest improvement in the trade account to yield a current account deficit excluding grants of CFAF 99.3, lower than 1985's level by CFAF 19.8 billion but still 17.4% of

140

GDP. When the effect of lower grants is taken into consideration, the decline of the current account including grants becomes even smaller for 1986; as the capital account improved only modestly, the overall balance recorded a deficit of CFAF 17.7 billion, only CFAF 4 billion lower than in 1985. This deficit was financed mainly through an increase in net foreign liabilities of CFAF 13.4 billion and unpaid debt service obligations being renogotiated of CFAF 3.9 billion. External arrears totaling CFAF 1.8 billion were repaid at the beginning of the year, but external arrears of CFAF 1.9 billion were accumulated in the last quarter of 1986.

The persistent external and fiscal deficits have resulted in the growth of both domestic and foreign debt. The growth in domestic debt, which primarily represents State borrowing from the commercial banking system, has assumed alarming proportions. In 1983 the domestic debt totalled 49% of GDP. By 1985 the proportion had dropped to 30%, still a high percentage that implies the diversion of funds needed by the private sector.

The foreign debt has likewise grown rapidly in recent years, necessitating debt rescheduling and the infusion of debt relief. During the period 1982 to 1984, the foreign debt grew from $804.9 million to $960 million, despite the rescheduling of debt during that period. This increased the ratio of debt to GDP from 78% to 107%, and the debt-service ratio from 6.4% to 12.2%.

b. Implications of Key Problems for the Financial Sector

The persistence of problems plaguing the economy as a whole have greatly complicated the task of the financial sector. Indeed, even assuming optimal conditions provided by financial sector regulation and superior management of the sector (neither of which can be counted on), the very adversity of the macroeconomic environment imposes constraints on the performance of the financial sector and implies that a less than efficient allocation of financial resources is almost inevitable until major structural reform is carried out.

The main ways in which the financial sector is affected by key economic problems include the following:

- Given the low per capita GDP level, it is not surprising that total consumption should account for a high proportion of GDP. Consumption has been above 95% of GDP since the beginning of the decade, and indeed has been steadily growing as a percentage of GDP as public consumption climbed with the increase in government spending and debt service commitments. Indeed, the savings rate has tended to be low for some time now, becoming negative in 1985. This naturally complicates the financial institutions' task of mobilizing domestic savings.
- The relatively high and unpredictable inflation rate act to discourage savings. Not only is consumption favored at the expense of savings, especially as deposit rate ceilings imply a relatively low return on deposits, but confidence in the monetary

system - and hence in financial intermediaries - is compromised by the instability of prices. The result has been:

- o A low rate of monetization, evidenced by a low ratio of M2 to GDP compared with most LDCs.
- o Greater confidence in real assets than in money or in financial liabilities as a store of value.
- o The persistence in certain areas of a barter economy.

- The uncertainty surrounding the economy, the instability fostered by unpredictable inflation, and the uncertain direction of public policy have combined to make lenders averse to long- or even medium-term commitment of their money. As a result, most financial institutions specialize in short-term lending. This may be adequate as far as the financing needs of the trade and other service sectors are concerned; it does, however, imply that credit will not be available for industrial and agribusiness schemes with long gestation periods.

- The huge deficits of the government and of public sector enterprises have resulted in massive borrowing from commercial banks, notably BDM. This has tended to divert financial resources away from domestic private enterprises, and has also implied that private sector enterprises are evaluated according to different standards than those applied to the public sector. This natural makes for an inefficient allocation of resources.

These constraints suggest that the problems of the financial sector cannot be viewed in isolation from those of the economy as a whole. In addition, however, it should be noted that a number of these problems are the direct result of the inefficiency of the financial sector. In particular:

- The level of confidence in the banking system is so low that, to the extent that savings are being undertaken at all, the commercial banks' role in mobilizing savings is very limited. This is evidenced by the following breakdown of savings in 1983, the last year for which a breakdown is available:

TABLE A

	1983 Millions of CFA Francs
Forced savings through parafiscal levies	2,500
Non-commercial transfers from Malians residing abroad	12,868
Voluntary savings in urban centers	917

SOURCE: BECIS Bamako

146

To include 100% of transfers from Malians residing abroad as savings is clearly inexact; it is estimated that at least 50% of these transfers goes toward consumption. In effect, of the items listed above, only the third one (voluntary savings in urban centers) represents an achievement for the financial sector; the other components of savings would have arisen regardless of the nature, or indeed of the existence, of a financial sector.

- The skewed distribution of commercial bank credit is one of the facts underlying the dim prospects for the growth of the industrial sector. The focus of commercial banks differs. The BDM specializes in extending credit to public sector enterprises, allocating credit almost independently of profitability criteria. Other banks which are more profit-motivated (notably BIAO and BOAM) are biased in favor of loans on which a quick return can be realized, which tends to dispose them to extend credit to the trade and service sectors.

The study will examine and evaluate the financial sector in Mali, both in terms of overall structure and of the performance of individual banks. The regulations to which the financial sector is subject, and their general implications to the sector and to the economy as a whole, will be discussed next. Subsequently, the role performed by the financial sector of the economy will be examined, with particular emphasis on the distribution of credit and how that differs from one individual bank to another. This will be followed by a discussion of recent trends in the government's fiscal and monetary policy, and of the major restructuring programs adopted by the government in recent years, and of what these have implied for the financial sector. Finally, the feasibility of financial sector reform will be examined, and recommendations will be made regarding the proper sequencing of such reform vis-a-vis other needed structural adjustment measures.

2. FINANCIAL SECTOR

a. Institutions

The banking sector in Mali comprises six banks of unequal size. These are:

- Banque de Developpement du Mali (BDM)
- Banque Nationale de Developpement Agricole (BNDA)
- Banque Malienne de Credit et de Depots (BMCD)
- Banque Internationale pour l'Afrique Occidentale-Mali (BIAO)
- Banque Libyo-Malienne (BALIMA)
- Bank of Africa Mali (BAM)

As can be seen from Table I (appendix), BDM is by far the largest bank in terms of percentage of total credit and of deposits (particularly government deposits). BDM and BNDA are both development banks, whereas the other four banks are

commercial banks. Three of the commercial bank, BIAO, BALIMA and BAM as well as BNDA came into existence in the early years of this decade. With the notable exception of BAM, all banks are partly or wholly owned by the government, which is a major actor in the financial sector through its control over BDM and BNDA. The government also owns slightly more than half of BMCD's stock, slightly less than half of BALIMA's stock, and 23% of BIAO's stock. There is no restriction on foreign ownership; indeed foreign institutions have a controlling interest in BIAO and BALIMA. BAM is wholly owned by the Malian private sector.

In comparing the nature and the performance of the different banks, we should note that different accounting standards and the uneven availability of data (particularly of recent data) make comparison difficult. Some general statements can, however, be made about the different banks, and the results of recently conducted market surveys can be examined to evaluate their comparative performance.

BDM is primarily the "public sector" bank; it is largely concerned with financing the production and marketing activities of the state enterprises and the state trading company, SOMIEX. This explains BDM's close links with the government, which kept nearly 95% of its deposits at BDM at the end of 1986, and also BDM's dominance of the credit market, its share of that market having been over 72% at the end of 1986. BDM is also the only bank that has access to Central Bank financing. BDM's position is highly unbalanced, however; it attracted no more than some 37% of non government deposits at the end of 1986.

Access to Central Bank credit facilities has proved imperative for BDM, given the high liquidity needs of the parastatal sector. Up to 60% of BDM loans were discounted with the Central Bank to provide the needed liquidity. Until recently, 40% of BDM loans were to the service sector, the remainder being equally divided between agriculture (primarily cotton and peanut marketing) and industry (primarily parastatal operations). Other lending activities included loans to small enterprises and pre-export financing (notably for gold and livestock exporters). Following a 1983-84 World Bank audit, however, BDM has been undergoing a major reorganization in the context of the larger overhaul of the parastatal sector. This reorganization will entail:

- The recapitalization of the bank to promote private capitalization
- Increased autonomy for BDM in operation management and lending policy
- Deposit base and loan portfolio diversification to reduce concentration on the private sector
- Improved loan selection, internal audit and risk evaluation procedures

150

These steps are in turn expected to result in:

- Cost-cutting reforms and expenditure rationalization
- The refinancing of rediscounted nonperforming loans
- Enhanced ability to marshal external funding for specialized development finance activities
- A more market-oriented strategy, entailing greater competition with commercial banks

The reorganization of BDM remains the key to financial sector reform -- indeed, to any attempt at economic restructuring -- in Mali. As will presently be seen, the donor community is a good deal more skeptical about attempts to reform BDM than had been the case a few months earlier. The stumbling block appears to be not BDM's management, but rather the government's own attitude, as it would like to continue to insure bank financing for the public sector deficit.

Financial data on BNDA are sparse, but its primary focus is known to be financing CMDT (Compagnie Malienne pour le Developpement des Textiles), which is responsible for managing the Mali Sud integrated rural development project. BNDA's main specialization is in rural and agricultural credit, including credit to small farmers, artisans and village associations and cooperatives, as well as to fisheries and food processing industries. Its primary objectives are:

- To diversify its portfolio away from loans to CMDT by cultivating two kinds of clients: other large rural development programs, like the Operation Haute Vallee, and small village associations and cooperatives.
- To expand operations through its provincial branches (at Mopti, Segou, Niono, Kuotialas and Sikasso), and its representative office at San while emphasizing profitability.
- Developing loan administration support systems through government and development agency extension programs.

BNDA's objective of tapping the informal or semi-formal market, consisting of village associations and cooperatives, is undoubtedly a praiseworthy social goal. It also provides for a reasonable return and minimum risk, since borrowers generally make an exceptional effort to meet their bank obligations to insure continued access to credit, and the whole solidarity network of the village organization can be called upon to honor the commitments of defaulters. Indeed, the default rate for rural credit is currently estimated at no more than 1%. At the same time, BNDA has moved rather slowly to increase overall lending activity to small village borrowers and to attract rural savings. Complicating BNDA's tasks are the following factors:

- To tap the informal market and mobilize rural savings in order to finance rural investment activities, it is first of all essential that village associations and cooperatives develop into genuine local savings institutions, with reliable accounting and

157

fund management.

- Some security for village association and cooperative funds deposited with BNDA must be provided, implying the need for some form of deposit insurance.

- BNDA must sort out its relationship with BDM, the only other bank with a major presence in the countryside. BDM in the past has formed consortiums with other banks, including BNDA and also the commercial banks, to provide rural financing. Commercial bank financing for rural borrowers is proving expensive; if BDM were to concentrate its rural efforts on cooperation with BNDA credit would be available to rural borrowers at some 5 percentage points lower than is currently the case, given BNDA's access to lower-cost funds.

BIAO is a private bank specializing in commercial banking activities. It is largely a foreign-owned bank with a substantial percentage of assets held by private Malian interests. Its primarily focus is on financing Mali's foreign trade. Other than its main headquarters at Bamako, it has two agencies in the provinces, at Mopti and Kayes, and a recently opened representative office at Manantali to finance the construction of the new dam there.

BIAO is considered one of the best managed banks in Mali, indeed, in all of West Africa. It has been able to gain the confidence of private sector clients, because of the high quality of its services, its reputation as a well-managed bank, and its status as a private bank. It has succeeded in attracting funds at an unusually low cost, estimated at some 3.5%. It has also been successful in drawing the savings of Malians working in France, where it has opened a branch in Paris.

At the same time, BIAO realizes a high average return on its loans, averaging some 10% in 1986. Liquidity presents no problem, although that in effect is symptomatic of selective credit controls that limit BIAO's ability to use the funds it has mobilized. Far from needing Central Bank financing, BIAO participates in financing the deficit of other banks, notably BDM, by buying placing funds on the money market. BIAO places some 10 billion CFA francs per year on the money market, realizing a return of some 7% to 8% per annum, in addition to funds placed on money markets of other UMOA countries. This state of affairs of course discourages the bank from mobilizing savings by offering deposit rates higher than money market rates, realizing in wasted potential resource mobilization.

BMCD is a commercial bank specializing in lending to commerce and industry. It has close links with the French Credit Lyonnais, which owns slightly less than half of its stock and regularly seconds executive officers at BMCD to provide technical assistance. BMCD has two branches at Bamako and one at Segou. The focus of its lending and deposit activities is the capital. It clientele includes private investors involved in trade and

four partially or wholly state-owned enterprises: CMDT, l'Energie du Mali, SONATAM and Pharmacie Populaire. All its loans to the private sector are guaranteed, but not so its loans to the public sector. To that extent it is subject to the problem that plagues BMD, that of holding a significant percentage of its portfolio (though far smaller than that held by BMD) in doubtful or nonperforming loans. On the whole, however, BMCD is regarded as a financially healthy, well-managed institution.

BMCD loans are unequally divided between major sectors. Commerce and hotels accounted for fully 63% of loans extended at the end of September 1985, manufacturing industries being the second in importance with 22% of total loans. Return on loans averages 12% per year, which implies a margin of 4% to 5%. At the same time, selective credit controls have hindered the growth of BMCD's credit. BMCD would particularly like to expand its credit in two areas:

- Middle-sized private enterprises
- Partially or wholly state-owned enterprises, provided it is permitted to evaluate risks and credit conditions freely (which credit controls currently preclude).

BAM (Bank of Africa-Mali, also BAM and BOAM) was founded in 1983 by a group of private Malian business through a public subscription that occurred in two stages, bringing the bank's capitalization to 650 million CFA francs. Since its inception, BAM enjoyed a number of advantages, namely:

- Being a private bank, it disposes of the confidence of private entrepreneurs
- It provides rapid teller service
- It provides speedy foreign trade transactions, and does not retain funds for any length of time (unlike BIAO and BMCD). It has a number of foreign correspondents in Europe and elsewhere in West Africa.
- It recruits employees among the best educated and selects them by using rigorous testing methods
- It enjoys complete autonomy in decision-making, not having to answer to a Paris-based administration like BIAO and BMCD

BAM's strategy has tended to focus on an aggressive courting of industrial and commercial enterprises and private businessmen. Its rapid penetration of the credit market has been mostly to the detriment of BDM. Nonetheless, it total share of the private market is no more than 5%, while its share of the total market is about 1%. These shares could rise as a larger number of public sector enterprises are privatized. On the whole, BAM is considered a bank of modest dimensions, but it has an excellent reputation as being well-managed and efficient, especially among private entrepreneurs. Thus far, it has extended credit according to strict criteria of profitability. It is based at Bamako and its operations are limited to the capital.

BALIMA was set up as a commercial bank in 1983. It is 51% owned by Libyan Arab Foreign Bank, the rest of the stock being held by the Malian government. Its operations are limited to Bamako, where it is based. Its penetration of the market was achieved through a major radio publicity and public relations campaign. It has primarily focussed on serving Malian entrepreneurs.

BALIMA's deposits come almost exclusively from the private sector. Nearly 85% of these deposits are sight drafts, and time deposits have a maturity of no more than 12 months. The cost of collection is around 5%. Some 80% of loans are in the form of short-term credits (3 to 6 months), the average return being 14.5%. BALIMA's strategy is regarded as extremely conservative and focused on high profit margins. This explains its limited share of total deposits and loans (1% of each).

b. Regulations

Until Mali joined UMOA (West African Monetary Union) 1984, its monetary policy was coordinated with France, with whom it maintained a fixed parity exchange rate. Credit was and continues to be subject to considerable controls. A rediscount mechanism was the main credit policy instrument used by the Central Bank of Mali. Discountable and non discountable loans were treated differently; banks exceeding their growth targets for non discountable loans were required to maintain interest-free balance with the Central Bank. A ceiling on rediscountable loans was also fixed both for banks (who were limited to a certain percentage of their deposits) and individual borrower. Special rediscount facilities were sometimes set up for the benefit of larger state enterprises. Annual ceilings, applicable to all banks, were set on the growth of non seasonal short-term credits, but no ceilings existed on the growth of medium- and long-term credits. Deposits and loans rates were fixed by the Central Bank.

These policies failed to curb the expansion of credit, which was fueled by the use of overdraft facilities to refinance loans. France put pressure on Mali to restrict rediscount operations in the late 1970s. A new banking law was enacted in 1979, requiring a minimum authorized capital (500 million MF) and setting up a special reserve fund (10% of net profits) and liquidity as well as stricter disclosure requirements. Although rediscounted obligations continued to grow in the 1980s, a reform program was adopted for the public sector that promises to curb credit growth.

With Mali joining the UMOA in June 1984, it was required to coordinate control of monetary and credit policy to the UMOA Council of Ministers, the Board of Directors of the West African Central Bank (BCEAO). It still maintains a National Credit Committee and Control Commission. It now shares a common currency with other UMOA member (the CFA france). Except for working balances, all financial institutions in member states are

required to place all foreign exchange holding with the BCEAO, which it turn places 65% of these in individual country accounts with the French Treasury.

The principal policy instruments used by UMOA include:

- Credit ceilings, in the form of annual credit budgets, set by UMOA and the National Credit Committee. These apply to BCEAO advances, purchases of government securities all (rediscount) credit extended to the banking system.
- Sectoral credit coefficients are used lending requirement guidelines.
- National Credit Committees are allowed to pre-approve loans over a certain amount at their discretion, including loans increasing the total liabilities of an individual borrower over a given ceiling.
- Interest rates for all deposits, loans and credit instruments are fixed and uniform for all member states. Interest rates were revised downward by BCEAO in March and again in September 1986. Money market rates, set by the Central Bank, declined by about 2.0% from November 1985 levels; nonetheless all money market rates remained positive in real terms. (See Table II).

c. Role of the Financial Sector

The recent creation of four commercial banks has altered the general orientation of the financial sector and added variety to the range of bank services, the methods of funding and the asset structure of the financial community. Basically, BDM and BNDA have acted as "development banks", BDM specializing primarily in financing state enterprises, and BNDA in providing rural financing, notably crop credit ("credit de campagne"). Little direct competition exists between the two institutions; as mentioned above, BDM has preferred to form consortiums with a broad range of commercial banks in addition to BNDA to finance its rural operations.

BDM is widely regarded as the most problematic bank in Mali. Given the high incidence of nonperforming loans in its portfolio (the result of substantial arrearage by the government and state enterprises), BDM is close to being technically bankrupt, and is kept alive essentially through credits (primarily in the form of rediscounting) from the Central Bank.

The four commercial bank (BIAO, BCMD, BALIMA, and BAM) provide very similar services, namely:

- Short-term credits in the form of loans and overdrafts, primarily to the commercial sector and to certain parastatals
- Discounting short-term obligations
- Underwriting of notes, bills and drafts so as to enable clients to obtain third party financing (primarily from a foreign supplier)
- Surety bonds, in the form of performance bonds or of

155

coverage for mandatory import duty deposits
- Letters of credit, usually utilizing total or partial cash collateral

In effect, then, while the development banks tend to be heavily specialized, the commercial banks tend to compete for much of the same market, especially as far as assets are concerned. Generally speaking, the privately owned commercial banks have a better reputation for high-quality management than the state-owned ones; also the services they provide to their clientele are better rated. This explains the growth in deposits and increase in profits they have experienced since they began operating. BIAO has been one the most successful banks in this regard; it has been able to tap into the growth in non demand accounts in recent years, and to build its clientele by providing a wider range of non funded services than the more firmly established BMCD. Through effective cash management BIAO has been able to cover fee-generating contingent liabilities and earn a high rate from the Central Bank and BDM.

On the whole, the financial sector in Mali possesses a number of positive features compared with other African countries surveyed in this report, namely:

- Monetary policy is subject to at least a measure of credit control, given the country's membership in UMOA.
- There is a fair degree of competition among commercial banks, and the state does not have a monopoly over banking
- Despite the persistence of double-digit inflation, the interest rate structure in place is such that a positive return on savings and time deposits can at least at times be realized
- Although the banks' ability to serve the needs of the rural sector remains limited, a number of institutions, notably BNDA, have had some success in establishing a wide credit network using the semi-formal sector (the village associations and credit unions).

At the same time, a number of defects in the structure of the financial system impede its proper functioning, namely:

- For the financial system as a whole, one of the most serious market deficiencies stems from the relative lack of medium- (to say nothing of long-) term financing. Nor are development banks any less guilty of predilection for short-term assets; BDM, in particular, specializes in short-term credits. (See Table III.) Most of the credit extended by Malian banks continues to be for trade and working capital financing, which leaves little for the financing needs of new expanding businesses, which typically require longer-term loans. This stems from the difficulty of obtaining information on productive enterprises, the high profitability to be derived from loans and client relationships with the commercial sector, and the natural aversion to commitment of funds for an

156

extended period.

- While banks other than BDM appear to apply reasonable standards in evaluating credit risk, there is still a good deal to be learned, especially by the private banks, in credit evaluation. This is especially imperative in sectors where information is sparse (e.g. agriculture and the collection costs are high
- Inadequate rural credit remains a problem, despite BNDA's relative success in penetrating the sector and expanding in rural areas. The main problem there, other than the difficulty of assessing the profitability of agricultural loans, is the relative lack of adequate funds at the disposal of institutions like BNDA.
- The perennial problems besetting BDM are ultimately the Achilles' heel of Mali's financial system. Given the huge arrearage from which the predominant BDM has been almost continually suffering, the very set up of the financial sector implies that a significant share of credit is diverted to financing government and parastatal deficits. Not only is this at the expense of potentially profitable credit-starved enterprises, but it also implies the impossibility of restoring stability to the financial management of the economy.

3. GOVERNMENT POLICIES AND THEIR IMPLICATIONS FOR THE FINANCIAL SECTOR

a. Fiscal Policy

Under pressure from the donor community and from France, Mali reduced its overall deficit on a commitment basis during the period 1982 to 1984. The deficit shrank from CFAF 12.5 billion (3.0% of GDP) in 1982 to CFAF 8.9 billion (1.9% of GDP) in 1984. This was accomplished through a series of reform measures aimed at strengthening tax administration and collection, and also at widening the tax rate, which yielded a 10.6% increase in government revenues from CFAF 50.6 billion (12.3% of GDP) in 1982 to CFAF 61.9 billion (13.2% of GDP) in 1984. Expenditure increased at the lower rate of 5.9% over that period, largely the consequence of an increase in the wage bill and in maintenance allocations.

Government revenues were boosted 14.1% in 1985 through a further improvement in tax collection and an upward revision in retail prices for petroleum products. At the same time expenditure climbed 8.6%, primarily the result of an increase in wages enacted by the government in March 1985 and in travel and representation expenses. On the whole, though the deficit situation remained under control, so that the deficit shrank further on a commitment basis to CFAF 5.9 billion (1.2% of GDP).

The deficit widened in absolute terms in 1986 to CFAF 6.9 billion, although the percentage of GDP it constituted remained constant at 1.2%. Nonetheless, the overall fiscal situation and its implications for the financial sector suggest some serious

157

problems, namely:

- The government's success in boosting revenue is being eroded by mounting expenditure. In 1986, revenues increased by an impressive 25.2% - a major collection effort (focussing on customs), as the loss in cotton revenue was only partly compensated by gold receipts. During that same year, however, government spending increased by 24.6%, due to an increase in personnel expenditure, travel, and representation. There was also an increase in expenditure of the annexed budgets and special funds, while extrabudgetary expenditure, which had previously not been monitored properly, was estimated at CFAF 6.7 billion in 1986.

- The government's revenue structure is heavily weighted toward indirect taxation, especially taxes on international trade. This dependency has increased during the period 192 to 1986, as the share of taxes on international trade in budgetary revenue rose from 41.1% to 41.8% over that period. This creates a number of problems, namely:

o Given the need for imported inputs of production, exemptions have had to be arranged for many items, creating administrative problems.

o The fact that taxes on international trade and on goods and services account for more than half of revenues implies a strongly consumption-based tax system, which is largely regressive and does not bode well for revenue growth. In particular, the taxes on imports are dependent on the continued flow of imports and appropriate import valuation.

- Financing the deficit has entailed heavy use of bank borrowing. The extent of bank financing of the deficit varies. In 1986, CFAF 5.6 was borrowed from the banking system, to cover a total deficit of CFAF 6.9 billion. Most of that was borrowed from BDM. Since the Central Bank is expected to discount a high proportion of BDM's loans, in effect converting them into long-term debt that government contracts through the UMOA system, Mali can be said to be no closer to fiscal discipline now than it was before it joined UMOA.

- The large fiscal deficits have also been partially funded by grants from foreign donors, which totaled CFAF 3.3 billion in 1986. At the same time, however, the high debt burden carried from previously accumulated debt necessitated amortization of CFAF 8.6 in 1986. Foreign debt remains a serious problem for Mali, and with continued foreign borrowing to cover the deficit, it can only get worse. In 1986 the debt service ratio rose to 25.1% from 21.1% in 1985, despite the CFAF 3.9 billion of debt relief under negotiations for that year.

- The extent of financial unsoundness of government accounts is sometimes distorted by the practice of arrearage. In 1985, for instance, the supposed improvement in the budgetary situation was at least in some measure due to a massive (CFAF 4.3 billion) increase in government arrearage, which effectively implied

158

borrowing from other state entities and, ultimately, from BDM.

- The deficits run by public enterprises further aggravate the financial situation. As can be seen from Table IV, SOMIEX and OPAM combined are the major contributors to that sector's deficit, which totaled an estimated CFAF 6.6 billion in 1985 -larger than the government's deficit that year. On the whole, the financial performance of the sector as a whole has shown little improvement in recent years; OPAM's deficit has shrunk steadily since 1982 but has remained large, while SOMIEX's performance has been deteriorating since 1983. Since these enterprises are large borrowers from the banking sector, the problem of diversion of bank funds that could be used to boost productive capacity arises.

b. Monetary Policy

In 1982 and 1983, broad money grew 8.6 and 15.4% respectively, reflecting primarily the growth in net bank credit to the government and in ordinary credit. Money growth accelerated in 1984 to 25.2% as credit to the government and to the economy continued to grow. Thereafter monetary policy was affected by Mali's membership in UMOA. Although bank credit increased 13.2% in 1985 and 18.5% in 1986, in both years the expansion was largely fueled by increased credit to the economy, while net bank credit to the government accounted for a smaller share of total credit expansion. Broad money increased 9.5% in 1985 and 5.2% in 1986, well below the nominal increase in GDP in the latter year. A major factor underlying the modest monetary growth in 1986 was the erosion of Mali's net foreign asset position, partly because of an adjustment by BCEAO of the coefficient used to calculate the number of Malian notes circulating in other UMOA countries.

Mali's re-entry into UMOA was warmly applauded by the donor community, since that step was expected to restore monetary stability. In particular, membership in UMOA was expected to mean the following for the Malian monetary system:

- Tighter control of monetary policy (and an eventual end to continued BDM financing of parastatal deficits)
- Greater stability and improved Central Bank management with the integration of national and regional decision-making
- A stronger, more convertible currency that would promote a higher level of financial sector activity
- Higher deposit rates on time and savings deposits, drawing funds from savers into the banking system

The main area in which the expectations of the donor community were dashed was perhaps the most critical, namely tighter control of monetary policy. The deficits run by parastatals were converted into long-term debt, and BDM's nonperforming loans to these parastatals were effectively cancelled. This had the advantage of improving BDM's financial standing in the short term, but as problems persisted, BDM's position continued to deteriorate, until it approached its

159

pre-1984 critical state toward the end of 1986.

The credit crisis which arose in 1986 was triggered by the rapid expansion of bank domestic credit, as the demand for ordinary and crop credit increased, and so did the government's financing needs. The surge was particularly pronounced in the second half of the year, as crop credit ("credit de campagne") expanded substantially. Soon the entire banking system was feeling the pinch, as many borrowers found themselves unable to liquidate stocks to repay loans. BDM was the major actor in the expansion of credit and one of the first banks to experience difficulties; it thus needed - and obtained - substantial financing from the Central Bank and from the domestic money market. The difficulties were made worse as many depositors, particularly large state enterprises, ran down their accounts.

Bank domestic credit thus increased fully 18.5% of beginning money stock in 1986, as all components of domestic credit registered an increase. Net bank credit to the government increased by 4.3% of domestic money stock (compared with a 2.3% increase in 1985). Another alarming jump was in the ordinary (as opposed to crop) credit, which expanded by 7.6 % of beginning money stock in 1986. Particularly alarming was the increased use of short-term, bank-guaranteed suppliers' credits (credit par signature), which were in effect transformed into medium- to long-term loans in many cases as clients defaulted on their obligations. Crop credit also jumped sharply, registering an increase equal to 6.6 percent of beginning money stock (compared with a 0.5% fall in 1985), a result of the difficulty of liquidating stocks and the good cotton harvest at the end of 1986.

c. Planning and Structural Adjustment Programs

Mali's relationship with the donor community has been less problematic than that of many other sub-Saharan communities. The period since 1980 has been especially promising, although a number of setbacks have resulted in complications. Interestingly, the state of the financial sector, particularly the management of BDM, has tended to be the most problematic element in foreign donor-sponsored reform programs.

The government began to formulate a comprehensive economic reform plan in 1980 in response to serious economic and budgetary problems. The main elements of this plan, which has the support of multilateral and bilateral donors, are the following:

- Reducing the role of government
- Monetary and fiscal reform
- Encouraging private enterprise and cereal marketing
- Pricing reform

A crucial issue in this plan is improved financial administration for both the government and the public sector, which ultimately entails reform of the management of BDM and a

redefinition of its role in the financial system.

The IMF and World Bank have worked closely with the Malian government on a reform package. Their experience was fairly satisfactory until the end of 1986. In the past few years Mali has had access to 3 consecutive IMF standby agreements which ended in March 1987. The World Bank meanwhile has worked with the government on projects to assist cotton cultivation and marketing and on highway development, which are now in their early stages but are reportedly going well. Two more projects were planned for 1986: one for l'Office du Niger (an irrigation project) and another for public enterprise reform, which would have entailed working on a structural adjustment loan from the IMF. The last-named project was the most problematic; it was to have involved using $57 million to wipe out cross-debt between state enterprises and financial institutions, and ultimately to have revolved around the reform of BDM. BDM's problems (excessive staffing, very poor management, bad debt collection record from both the public and private sector) are regarded by the bank as being the core issue in public enterprise reform; as long as BDM is used to finance the deficits of bankrupt public enterprises, true fiscal reform will remain elusive in Mali. The World Bank's reforms for BDM include:

- Opening up its capitalization to the private sector
- Developing a management for the bank independent of the government
- Improving the managerial skills at BDM, especially in the area of credit evaluation

The optimism about Mali's prospects for serious reform foundered in the second half of 1986, when, as mentioned above, domestic banking experienced a crisis that necessitated the transformation of bank-guaranteed credits into medium- and long-term debt. This crisis was directly precipitated by the arrearage accumulated by the government and the public sector, which in turn tightened liquidity. The net result has been an expansion of credit above the ceiling levels approved by the IMF. As a result, Mali did not make the final two drawings of its last IMF standby credit, and currently does not dispose of an IMF credit facility. Meanwhile the public enterprise reform program sponsored by the World Bank is on hold, given the government's reluctance to restructure BDM. However, the IMF and the World Bank remain optimistic that dialogue will be re established in the near future.

USAID programs in Mali have included individual development projects, the Cereals Marketing Restructuring Program (PRMC), and the African Economic Policy Reform Program (AEPRP), and emergency assistance in response to the drought and locust infestation. The key elements in USAID's strategy in Mali appear to be:

- Concentrating assistance resources in the agricultural sector in a few zones with good production potential

161

- A strong focus on agricultural pricing and policy reforms, improved project planning and management, agricultural research, and strengthening extension and training

- Promoting reforms by linking aid to the implementation of reform programs, notably tax reform (reducing tax-related disincentives to local processing), reduced price controls, a liberalized commercial code, a restructuring of budgetary expenditures, and public enterprise reform and reduction.

Progress has been made by the government in tax reform and, to a limited extent, in reducing redundancies in the civil service. As Phase II of the AEPRP is contemplated after 1988, the emphasis -- subject to the availability of funds -- is to be on tax and budgetary reforms. USAID is in agreement with the multilateral aid agencies that parastatal divestiture has proceeded very slowly, and sees the experience of 1986 as a setback.

Given the existence of private banking institutions, USAID has considered the option of making assistance available to selected sectors through private banks. A project was set up for a reform program initiating a bank guarantee mechanism for developing complementary actions designed to reconvert civil servants to private business. Another project suggested (but rejected following a feasibility study due to doubts about bank personnel possessing the necessary expertise) was to provide BAM with a credit facility to make loans to small businesses. A crucial problem that has arisen in dealing with such projects, apart from inadequate skills (which can be remedied through training) is the tight quantitative credit controls existing in the system, which, given the fact that BDM currently dominates the market and that credit expansion coefficient are applied uniformly to all banks, leaves little room for the growth of more recently established banks even if credit facilities are made available by foreign donors.

c. CONCLUSIONS AND RECOMMENDATIONS

A number of reforms are necessary if Mali's financial sector is to play a meaningful role in promoting the country's economic growth. These include:

- A far-reaching reform of BDM is essential, not only for the health of the financial sector (many banks being net lenders to BDM through the money markets), but for the health of the economy as a whole, since it is BDM's role as a lender to the public sector that validates the huge public sector debt and encourages fiscal irresponsibility.

- Credit ceilings must be applied selectively to banks. Given that BDM dominates the credit market, applying uniform ceilings to all banks hinders the expansion prospects of BNDA and of the commercial banks, which are at an early stage of their development.

167

- Improved training must be provided to personnel in all banks. Here the use of a pilot training program would be beneficial; emphasis should be given to developing the banks' ability to train personnel to act as instructors in future programs. The emphasis should be on budgetary planning, credit evaluation, and improved auditing. Such training is imperative before credit facilities can be channeled through selected banks in any significant amount.

The most important of these reforms, namely the reform of BDM, remains an elusive goal. There is, however, reason to believe that the government's reluctance to restructure BDM may soften somewhat if a dialogue is established with the IMF and World Bank; indeed, until recently Mali's response to structural adjustment programs has tended to be positive.

There is also scope for further study of Mali's financial sector. It should be noted, however, that the amount of information available on the sector is quite impressive, though much of it is French. On the whole, though, the following areas bear further scrutiny:

- The current system for allocating credit and what effect it has on sectoral and geographic balance
- The extent to which the uniform application of credit controls has had an adverse effect on the rural sector. This should entail in particular a study of the constraints facing BNDA and BMCD, the two banks active in the rural sector, as a result of credit controls, and the possibility of expansion if controls were relaxed.
- Studies of the informal and semi-formal financial sectors, on which information is still very sketchy. This should include a study of:

  o The role of informal financial sectors in livestock and crop exports

  o The village associations and cooperative, how they function, how they relate to the formal financial sector, and what system of control they use.

163

BIBLIOGRAPHY

"La Banque et le Developpement de l'Afrique Noire: Benin, Cameroun, RCA, Congo, Cote d'Ivoire, Gabo, Haute Volta, Mali, Mauritanie, Senegal Tchad, Togo", Ediafric la Documentation Africaine, Paris (1982)

Birdsall, Nancy; Orivel, Francois; Ainsworth, Martha; and Chuhan, Punham, "Three Studies on Cost Recovery in Social Sector Projects", World Bank, Washington, D.C. (1983)

Centre Inter, "Etude par le Cifpb du Role Futur de la Banque de Developpement du Mali", Manuscript (Paris: 1986).

Equator Advi., "Business Plan for Bank of America - Mali", Manuscript (Washington, D.C.: 1987).

Puttemans, R., "Economic Reform Program: Mechanism of Bank Grarantee", Manuscript (Washington, D.C.: 1985).

Table I

	% des Crédits	% des Dépôts Particuliers	% des Dépôts Gouvernement	% Crédit BCEAO
BDM	72,2 %	36,9 %	94,9 %	100 %
BIAO	8,3 %	30,4 %	-	-
BMCD	10,5 %	19,6 %	1,5 %	-
BNDA	6 %	3,5 %	1,8 %	-
BOAM	1,4 %	5,2 %	-	-
BALIMA	1,6 %	4,4 %	1,8 %	-
	100 %	100 %	100 %	100 %
TOTAL Millions F CFA	77 090	56 318	14 691	28 397

Source: Etude par le CIFPB du Role Futur de La Banque de Development du Mali (Oct. 1986), Centre International de Formation de la Profession Bancaire, Paris

Table II Mali: Structure of Lending and Deposit Rates Applied by Commercial Banks from September 22, 1986 to Date

Lending rates	
1. Crop financing, financing of storage of agricultural products, and export credits for agricultural commodities 1/	7.0-8.0
2. Short-, medium-, and long-term credit 1/ to small- and medium-sized national enterprises with outstanding credit of less than CFAF 30 million and loans 1/ to nationals for home building 2/	7.0-9.0
3. Other short-, medium-, and long-term credits	8.5-13.5

Deposit rates	Up to CFAF 200,000	From CFAF 200,000-CFAF 500,000	From CFAF 500,000-CFAF 2 million	Over CFAF 2 million 3/
Sight deposits 4/	--	--	--	--
Time deposits 5/				
Less than 6 months	4.25	4.75	5.25	5.75
6 months-less than 1 year	5.25	5.75	6.50	7.00
More than 1 year 3/	6.25	7.00	7.50	8.00
Certificates of deposit 6/				
6 months-less than 1 year	5.25	5.75	6.50	7.00
More than 1 year 3/	6.25	7.00	7.50	8.00
Savings deposits	6.50	6.50	6.50	6.50

Source: Data provided by the BCEAO.

1/ If rediscountable at the central bank at the preferential rate.
2/ For borrower's first primary residence with a maximum of CFAF 15 million.
3/ Minimum rates.
4/ Since January 1, 1985 deposit money banks are no longer required to remunerate sight deposits.
5/ Advances on time deposits can be accorded at a rate corresponding to the rate of interest paid on such deposits, plus 1 percent.
6/ Minimum certificate of deposit is CFAF 5,000.

Source: Central Bank figures and IMF staff estimates

TABLE III

BDM, PORTFOLIO ANALYSIS, AS OF 30 SEPTEMBER, 1985

1 - STRUCTURE OF LIABILITIES

1.1 PREPONDERANCE OF SHORT-TERM CREDITS

	SEPT. 84		SEPT. 85		CHANGE	
	Thousands of CFA Francs					
Short Term	44,569	85%	56,739	85%	+12,170	+27%
M./L. Term	7,794	15%	9,315	15%	+ 1,521	+20%
	52,363	100%	66,054	100%	13,691	+26%

Source: Etude par le CIFPB du Role Futur de la Banque de Developpement du Mali (Oct. 1986), Centre International de Formation de la Profession Bancaire, Paris.

Table IV Mali: Net Operating Results of the Major Public Enterprises, 1982-85

(In millions of CFA francs)

	1982	1983	1984	1985 Est.
I. Enterprises under the supervision of the Ministry of State Enterprises				
SOMIEX (import-export)	-1,098	-160	-2,255	-3,301
Export activities	(2,194)	(1,968)	(...)	(...)
Domestic distribution	(-3,292)	(-2,128)	(...)	(...)
Air Mali (air transport)	-907	-715	-686	...
EDM (electricity and water)	127	135	-597	542
COMATEX (textiles)	-444	-728	-1,176	-561
ITEMA (textiles)	19	217	310	390
PPM (pharmaceuticals)	335	193	85	-499
SEPAMA (groundnut oil processing)	-134	-100	-340	-237
SEPOM (refined groundnut oil, sheanut butter, soap)	-178	-191	228	141
SMECMA (agricultural equipment)	20	40	-240	-670
SONATAM (cigarettes and matches)	203	305	203	318
OPAM (cereal marketing)	-1,560	-1,415	-1,383	-1,029
Total	-3,617	-2,419	-5,851	-4,895
II. Other enterprises				
RCFM (railways)	-1,469	-1,417	-1,047	-2,209
OPT (post and telecommunications)	-247	129	333	527
Total (I + II)	-5,333	-3,707	-6,561	-6,577

Sources: Data provided by the Malian authorities; and IMF staff estimates.

1/ Since 1984, SOMIEX no longer retains the profits from exports of cotton, but receives a small fixed commission for various services it still provides with regard to cotton exports.

168

Table V. Mali: List of Deposit Money Banks at End-December 1986

	Shareholders	Year established	Capital (CFAF million)	Deposits 1/ (CFAF billion)	Number of branches
Banque de Développement du Mali (BDM)	Government: 100 percent	1968	2,550	41.0	13
Banque Nationale de Développement Agricole (BNDA)	Government: 55 percent Caisse Centrale de Coopération: 20 percent BCEAO: 15 percent BDM: 10 percent	1981	1,000	3.9	7
Banque Internationale pour l'Afrique Occidentale au Mali (BIAO-Mali)	Banks: 77 percent Private national shareholders: 23 percent	1980	975	21.8	4
Banque Malienne de Crédit et de Dépôts (BMCD)	Government: 51 percent Crédit Lyonnais: 49 percent	1979	800	11.4	3
Banque Arabe Libyo-Malienne	Government: 49 percent Foreign Arab banks: 51 percent	1982	500	2.5	1
Bank of Africa-Mali	Private national shareholders: 70 percent Private foreign shareholders: 30 percent	1982	650	3.1	1

Sources: Data provided by the Malian authorities; and IMF staff estimates.

Table VI Mali: Gross Domestic Product
at Constant Prices, 1983-86

(Annual percentage change)

	1983	1984	1985 Est.	1986 Prel. est.
Primary sector	-11.5	-8.0	-7.4	17.2
Traditional agriculture 1/	-6.0	-7.6	-14.5	25.3
Modern agriculture 2/	-26.4	-20.5	2.8	20.0
Livestock	-16.9	-6.5	3.0	5.5
Secondary sector	7.9	3.7	4.1	7.5
Industry and mining	6.8	33.4	-1.5	8.0
Construction and public works	10.0	-16.3	10.0	7.8
Handicrafts	1.5	1.5	5.0	2.5
Tertiary sector	6.1	11.0	3.9	1.3
Public administration	14.5	11.7	0.5	1.0
Trade	0.1	5.7	5.0	0.3
Transportation	11.6	28.9	4.8	-0.4
Other services	7.6	11.0	5.0	5.0
Gross domestic product	-4.1	-0.1	-1.7	9.6

Sources: Data provided by the Malian authorities; and IMF staff estimates.

1/ Includes cereals, forestry, and fishing.
2/ Includes cotton, groundnuts, tobacco, fruits, vegetables, and other.

170

Table VII Mali: Origin and Use of Resources, 1982-86

	1982	1983	1984	1985 Est.	1986 Est.
	(In billions of CFA francs)				
Gross domestic product	411.7	421.7	470.1	493.1	572.0
Consumption	393.9	413.6	469.3	516.6	549.1
Domestic savings	49.9	40.2	32.9	46.0	--
Investment	84.6	86.4	87.2	95.9	122.6
Of which: changes in stocks	(3.8)	(-3.7)	(2.4)	(-9.1)	(9.5)
Resource gap	-66.8	-78.4	-86.4	-119.4	-99.7
Exports of goods and nonfactor services	62.4	78.4	101.7	102.2	86.3
Memorandum items:	(In percent of GDP)				
Consumption	95.7	98.1	99.8	104.8	95.9
Domestic savings	4.3	1.9	0.2	-4.8	4.1
Investment	20.5	20.5	18.5	19.4	21.4
Resource gap	-16.2	-18.6	-18.3	-24.2	-17.3
Exports of goods and nonfactor services	15.2	18.6	21.7	20.7	15.2
Imports of goods and nonfactor services	-31.4	-37.2	-40.0	-44.9	-32.5
	(In percent)				
Growth of nominal GDP	8.2	2.4	11.5	4.9	16.0

Sources: Data provided by the Malian authorities; and IMF staff estimates.

Table VIII Mali: Balance of Payments, 1982-86

(In millions of SDRs) 1/

	1982	1983	1984	1985	1986 Prel. est.
Exports, f.o.b.	171.2	154.1	188.5	177.8	163.6
Of which: cotton	(51.1)	(69.1)	(96.4)	(79.4)	(65.8)
Imports, f.o.b.	-211.6	-229.6	-250.1	-288.0	-259.6
Of which: cereals	(-13.4)	(-25.1)	(-51.9)	(-46.0)	(-17.5)
Trade balance	-40.4	-75.1	-61.6	-110.2	-96.0
Services (net)	-129.6	-140.1	-131.7	-171.9	-170.0
Of which: interest obligations	(-25.9)	(-23.)	(-18.9)	(-20.4)	(-20.4)
Private transfers	26.2	21.4	20.5	21.0	21.4
Current account, excluding public transfers	-143.9	-193.5	-192.8	-261.1	-244.6
Public transfers	84.3	101.8	128.1	143.4	115.5
Current account, including public transfers	-59.6	-92.0	-64.7	-117.7	-129.1
Capital account	70.9	78.2	63.8	70.1	85.5
Private (net)	-2.5	--	9.9	2.1	-4.9
Public	73.4	78.2	53.9	68.0	90.4
Disbursements	(80.4)	(89.1)	(6[illegible].2)	(93.6)	(114.8)
Amortization	(-7.0)	(-10.9)	(-15.3)	(-25.6)	(-24.4)
Debt relief 2/	20.9	16.2	4.5	--	--
Overall balance	-7.6	3.5	3.6	-47.6	-43.6
Financing	7.6	-3.5	-3.6	47.6	43.6
Obligations under renegotiation	4.0	4.8	9.9	11.4	9.6
International reserves	12.4	-2.1	-8.8	32.7	49.5
Central bank	16.1	4.8	-1.4	10.6	...
Of which: operations account	(-7.0)	(-6.3)	(-14.4)	(7.0)	(...)
IMF (net) 3/	(24.3)	(12.8)	(19.0)	(4.9)	(-8.4)
Commercial banks	-3.7	-6.9	-7.4	22.1	...
Special adjustment 4/	...	...	...	...	-15.8
Arrears	-8.8	-5.2	-4.7	3.5 5/	0.3 5/

Source: Data provided by the Malian authorities; and staff projections.

1/ CFAF/SDR average exchange rate: 1982: 362.8; 1983: 407.4; 1984: 445.0; 1985: 436.2; 1986: 406.0.
2/ Includes interest on the operations account and obligations under various bilateral debts for which agreements on rescheduling have been reached.
3/ Includes Trust Fund.
4/ Compensation to neutralize the effect on the balance of payments of the adjustment of the coefficient estimating the amount of Malian bank notes circulating in other member countries of WAMU.
5/ Excludes payment of Air Mali's external arrears.

Sources: Data provided by the Malian authorities; and IMF staff estimates.

172

Table IX Mali: Government Revenue, 1982-86

(In billions of CFA francs)

	1982	1983	1984	1985	1986 Est.
Taxes on net income and profits	7.1	7.6	8.0	9.0	8.0
Enterprises	5.0	5.1	5.4	5.9	4.7
Of which: public enterprises	(0.9)	(0.7)	(0.8)	(0.6)	(0.5)
private enterprises	(2.6)	(2.5)	(2.8)	(3.2)	(3.1)
Individuals	2.1	2.5	2.6	3.1	3.3
Of which: assessment	(0.6)	(0.5)	(0.5)	(0.7)	(0.7)
withholding	(1.2)	(1.7)	(1.9)	(2.1)	(2.3)
Property taxes	0.7	0.6	0.6	0.5	0.6
Taxes on goods and services	5.7	7.1	7.8	8.4	9.9
General sales taxes	4.1	5.3	5.8	6.2	7.6
Of which: public enterprises	(1.2)	(1.5)	(1.9)	(2.2)	(2.2)
private enterprises	(2.8)	(3.8)	(3.9)	(3.5)	(4.7)
Excise tax	1.6	1.8	2.0	2.2	2.3
Taxes on international trade	16.1	18.1	19.7	22.0	24.5
Customs duties	0.8	0.9	1.1	1.3	1.5
Other import charges	4.8	5.8	5.7	6.7	7.1
Sales tax on imports	6.2	6.7	7.8	9.3	10.0
Petroleum import duties	2.5	2.5	2.2	2.1	2.6
Payment of deferred taxes	1.2	1.2	1.9	2.0	2.6
Export taxes	0.5	0.8	0.7	0.3	0.3
Other	0.1	0.2	0.3	0.3	0.4
Other tax revenue	8.1	7.7	6.2	7.1	8.8
Head tax	3.2	3.2	2.5	2.0	2.6
Cattle tax	0.9	0.8	0.4	0.2	0.4
Stamp duties	2.1	1.8	1.1	2.3	2.2
Payment of tax arrears	1.9	1.6	1.9	2.2	3.3
Other	0.1	0.3	0.3	0.4	0.3
Total tax revenue	37.7	41.1	42.3	47.0	51.8
Nontax revenue	1.5	1.7	4.8	6.7	6.8
Of which: cotton	(--)	(--)	(2.1)	(4.1)	(0.6)
gold	(--)	(--)	(--)	(--)	(3.0)
Total budgetary revenue	39.2	42.7	47.2	53.7	58.6
Annexed budgets and special funds	11.4	12.1	14.7	17.3	23.5
Total revenue	50.6	54.8	61.9	70.6	82.1 1/

Sources: Data provided by the Malian authorities; and IMF staff estimates.

1/ Excludes an amount of CFAF 6.8 billion received through compensation.

113

THE WEFA GROUP

OCT 13, 1987

MALI

MACROECONOMIC VARIABLES

	80	81	82	83	84	85	86
GROSS NATIONAL PRODUCT, MILL US$	1681.2	1398.6	1253.6	1103.1	1065.6	1134.7	NA
GNP PER CAPITA, US$	236.8	191.6	167.1	143.3	133.2	138.4	NA
EXPORTS, FOB, MILL US$	205.3	154.6	145.8	330.1	409.2	361.0	383.5
CURRENT ACCT. BAL. MILL US$	-129.9	-143.0	-115.3	-113.2	-116.9	-113.1	-148.7
TOTAL EXTERNAL DEBT, MILL US$	693.2	745.3	823.0	942.8	1153.1	1327.4	NA
CONSUMER INFLATION, 1980=100	NA	NA	NA	NA	NA	NA	NA
US$/FRANC, PERIOD AVERAGE	0.005	0.004	0.003	0.003	0.002	0.002	0.003
POPULATION, MILL.	7.1	7.3	7.5	7.7	8.0	8.2	NA

MONETARY SURVEY

	80	81	82	83	84	85	86
MONEY SUPPLY, M2, BILL. FRANCS	NA	NA	NA	NA	117.4	127.6	NA
CONSUMER INFLATION, 1980=100	NA	NA	NA	NA	NA	NA	NA
WHOLESALE PRICE INDEX,1980=100	NA	NA	NA	NA	NA	NA	NA
DISCOUNT RATE	6.0	6.0	6.0	6.0	10.5	10.5	9.9
COMMERCIAL PRIME RATE	NA	NA	NA	NA	NA	NA	NA
GOVT. BOND YIELD, MEDIUM TERM	NA	NA	NA	NA	NA	NA	NA
DEGREE OF MONETIZATION	NA	NA	NA	NA	NA	NA	NA

MALI

CONSOLIDATED BALANCE SHEET OF
DEPOSIT MONEY BANKS
BILLION FRANCS

	80	81	82	83	84	85	86
ASSETS							
RESERVES	NA	NA	NA	NA	10.9	12.8	NA
FOREIGN ASSETS	NA	NA	NA	NA	11.7	5.8	NA
CLAIMS ON GOVT.	NA	NA	NA	NA	2.6	2.6	NA
CLAIMS ON PRIVATE SECTOR	NA	NA	NA	NA	78.1	95.1	NA
LIABILITIES							
DEMAND DEPOSITS	NA	NA	NA	NA	53.4	49.7	NA
TIME AND SAVINGS DEPOSITS	NA	NA	NA	NA	10.3	13.8	NA
FOREIGN LIABILITIES	NA	NA	NA	NA	12.6	17.0	NA
GOVT. DEPOSITS	NA	NA	NA	NA	6.0	10.5	NA
CREDIT FROM CENTRAL BANK	NA	NA	NA	NA	6.9	20.7	NA
CAPITAL ACCOUNTS	NA	NA	NA	NA	NA	NA	NA
VALUATION ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
OTHER ITEMS, NET	NA	NA	NA	NA	10.7	2.3	NA

BALANCE SHEET OF CENTRAL BANK

	80	81	82	83	84	85	86
ASSETS							
FOREIGN ASSETS	NA	NA	NA	NA	12.8	8.5	NA
CLAIMS ON GOVT.	NA	NA	NA	NA	90.4	96.6	NA
CLAIMS ON OFFICIAL ENTITIES	NA	NA	NA	NA	NA	NA	NA
CLAIMS ON COMM. BANKS	NA	NA	NA	NA	NA	NA	NA
CLAIMS ON SPECIAL BANKS	NA	NA	NA	NA	12.5	20.6	NA
LIABILITIES							
RESERVE MONEY	NA	NA	NA	NA	63.6	71.8	NA
OF WHICH							
CURRENCY OUTSIDE BANKS	NA	NA	NA	NA	50.5	59.8	NA
QUASI-MONEY DEPOSITS	NA	NA	NA	NA	NA	NA	NA
FOREIGN LIABILITIES	NA	NA	NA	NA	41.0	39.3	NA
CAPITAL ACCOUNTS	NA	NA	NA	NA	NA	NA	NA
RESCHEDULING ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
VALUATION ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
OTHER ITEMS, NET	NA	NA	NA	NA	11.0	14.8	NA

MALI

GOVERNMENT FINANCE
BILLION FRANCS

	80	81	82	83	84	85	86
DEFICIT(-)/SURPLUS(+)	NA	NA	-31.5	-34.5	NA	NA	NA
REVENUE	NA	NA	52.7	54.6	NA	NA	NA
EXPENDITURE	NA	NA	114.8	129.5	NA	NA	NA
FINANCING							
DOMESTIC	NA	NA	1.5	4.7	NA	NA	NA
FOREIGN	NA	NA	28.3	29.9	NA	NA	NA

INTERNATIONAL DEBT
MILL. US$

	80	81	82	83	84	85	86
TOTAL EXTERNAL DEBT, (EDT)							
LONG-TERM DEBT	693.2	745.3	823.0	942.8	1153.1	1327.4	NA
PUBLIC AND PUBLICALLY GUARANTEED	693.2	745.3	823.0	942.8	1153.1	1327.4	NA
PRIVATE NONGUARANTEED	0.0	0.0	0.0	0.0	0.0	0.0	NA
USE OF IMF CREDIT	11.4	7.8	34.2	46.3	63.7	80.8	NA
SHORT-TERM	23.0	71.0	17.0	19.0	60.0	61.0	NA
TOTAL LONG-TERM DEBT							
DEBT OUTSTANDING AND DISBURSED	693.2	745.3	823.0	942.8	1153.1	1327.4	NA
DISBURSEMENTS	102.8	112.0	116.1	156.7	122.1	105.5	NA
PRINCIPAL REPAYMENTS	6.1	6.1	3.4	7.7	11.6	25.4	NA
NET FLOWS	96.7	105.9	112.7	149.0	110.5	80.1	NA
INTEREST PAYMENTS	3.4	3.5	5.6	6.8	8.1	12.5	NA
NET TRANSFERS	93.3	102.4	107.1	142.2	102.4	67.6	NA
TOTAL DEBT SERVICE	9.5	9.6	9.0	14.5	19.7	37.9	NA
PRINCIPAL RATIOS							
TOTAL EXTERNAL DEBT							
EDT/XGS)	277.1	411.4	459.6	482.9	548.5	681.8	NA
EDT/GNP)	43.3	58.9	69.7	91.4	119.8	129.5	NA
INTERNATIONAL RESERVES	25.6	24.9	25.3	23.4	32.4	28.6	NA

176

E. NIGER

1. MACROECONOMIC SURVEY

a. Introduction and Discussion of Key Problems

Niger's economic development since Independence has been characterized by the pattern of boom and bust typical of many African countries. In Niger, the boom period of 1975 to 1980 was driven primarily by favorable external factors, mainly a soaring world market for uranium, although favorable climatic conditions also contributed to domestic growth. During the period 1981 to 1984, the economy was in crisis, suffering from a drop in uranium prices, depreciation of the CFA franc vis-a-vis the US dollar, and in 1984, closure of the border with Nigeria and a devastating drought. Since 1983, the government has undertaken major stabilization reforms with IMF assistance; these have been complemented by debt relief and economic adjustment programs supported by the donor community.

The government's expansionary fiscal policies during the boom period set the stage for the crisis period which followed. Gross fixed investment averaged about 25% of GDP between 1977 and 1980 and government expenditure doubled over this same period, from a level of 16.5% of GDP to 23.6% of GDP. Development expenditures tripled between 1978 and 1980, accounting for almost 50% of total government spending, and providing for a heavy buildup of infrastructure and state-owned enterprises. Niger also benefitted from large flows of international assistance during this period; net flows of foreign capital increased from about US$65 million in 1978 to about US$154 million in 1980, over half of which was in the form of multilateral and bilateral aid.

After the fall in world uranium prices and depreciation of the FCFA, gross fixed investment declined from a level of 25% of GDP in 1980 to 13% of GDP in 1984. Domestic revenues fell from being 13.7% of GDP in 1980 to 9.6% in 1985. The government was slow to adjust expenditure levels, which resulted in a large increase in the government deficit, from a level of 3.5% of GDP in 1979 to 10.9% in 1981. Real GDP showed an annual negative growth rate of -2.8% in the period 1981-84. External capital flows also declined during this period: private flows fell from US$124 million in 1981 to only US$35 million in 1983 and multilateral and bilateral aid disbursements dropped from US$160 million to US$91 million over the same period. The current account deficit increased to a high of 8.5% of GDP in 1980.

b. Stabilization Reforms - 1983 to 1986

Initial stabilization measures undertaken in 1983 were aimed at reducing the government and trade deficits. Specific actions included an immediate reduction in the level of new foreign borrowings on non concessionary terms, a freeze of government salaries and wage levels, and a cutback in the development budget. These measures were accompanied by a broad-based

177

adjustment program supported by three successive IMF stand by agreements, annual debt rescheduling agreements, French exceptional budgetary assistance, World Bank structural adjustment financing (a 3-year program which began in 1986), and USAID non project sector assistance. Structural adjustment reforms have targeted five major areas:

(1) In the area of monetary reform, limitations were set on growth of money supply, domestic credit and net credit to the Government. In 1985, the money supply was stabilized at a growth rate of about 10%, and the growth of domestic credit was reduced from 20% to 43% per year between 1979-82 to an average of only 2.3% in the years 1983-85. However, net credit to the Government has increased sharply since 1983: it grew by 23% in 1984 and just under 20% in 1985. These figures do not include credit to parastatal enterprises, which is classified as "non governmental" and for which we have no recent figures.

(2) In the area of public resource management, expenditures were reduced (primarily by lowering subsidies, reducing the wage bill, and cutting the development budget), and revenues were increased. On the revenue side, a major study of the tax system was carried out by the IMF, and a comprehensive tax reform program was undertaken. As a result of these combined efforts, the fiscal deficit as a percentage of GDP was reduced from a level of 10.9% in 1981 to 4.8% in 1985.

(3) In the area of external debt management, measures to reduce foreign borrowing and increase lending on concessional terms were coupled with efforts to improve donor coordination. By the end of 1985, arrears in foreign debt payments had been eliminated.

(4) Major steps were taken to reform the parastatal sector. These included divestment of approximately half the parastatal enterprises (22 out of 54), improvement in efficiency of these enterprises and recapitalization with private sources. A new Ministry of Public Establishments and Enterprises was created to oversee these reforms.

(5) A number of critical policy measures were adopted for the agricultural sector. Reforms in the national system of grain pricing and marketing were undertaken; subsidies on farm equipment were eliminated in 1985; agricultural research programs were evaluated and priorities reorganized; and a major study of the rural and agricultural credit system was undertaken (USAID-financed Ohio State University study, completed January 1987). Further reforms were also undertaken to progressively liberalize pricing and marketing controls.

In summary, since 1983, the government has undertaken extensive reforms aimed at stabilizing and adjusting the economy. Stabilization measures have been relatively successful in (i) reducing the fiscal deficit from a level of about 11% of GDP in 1981 to about 5% of GDP in 1985; (ii) reducing the current

118

account deficit from a high of 8.5% of GDP in 1980 to 7.5% of GDP in 1985 (with even lower levels in 1983 and 1984); and (iii) securing substantial debt relief and a restructuring of deficit financing to include higher proportions of concessionary aid. However, despite these improvements, economic recovery to date has been slow. GDP at constant prices declined from 1980 through 1984, drought in 1984 resulting in a major downturn in that year. The economy recovered slightly in 1985, with an increase in real GDP of about 6%, thus regaining pre-drought levels. GDP growth estimates for 1986 are about 4% in real terms.

c. Current Situation and Medium-Term Development Prospects

As of 1985, the population of Niger was about 6.1 million, with an estimated annual population growth of 2.8%. About 90% of the population lives in the rural areas, with a heavy concentration in the more arable regions of the south (an estimated 238 inhabitants per square kilometer in these areas). GDP per capita in 1985 was about US$257 equivalent. The rural sector, consisting largely of subsistence agriculture and livestock activities, accounted for 49% of GDP (at factor cost); with mining, mainly uranium, contributing about 9%; transportation, commerce and services, 25%; construction and public works, 6%; and government, 8%. The medium-term development prospects for Niger are poor, due to the limited potential for recovery in the mining sector, lack of strong technical packages to increase agricultural productivity, and projected slow growth in the industrial sector, which will continue to be dominated by troubled parastatals, at least in the medium-term future. GDP in nominal terms is projected to grow at a modest 6-6.5% p.a., negligible growth in real terms. Growth is expected to come mainly from (i)the development of private sector services through gradual liberalization of government pricing and marketing structures, (ii)increased efficiency of the public sector, including improvements in resource mobilization and the human capital base, and (iii)improved profitability of the parastatal sector, through progressive divestiture and aggressive restructuring. The government will need to rely almost exclusively on concessional foreign aid to finance its medium-term investment program.

The prospects for continued adjustment and stimulation of new growth depend to an important extent on the capacity of the financial sector to respond to new challenges within the context of limited monetary and credit growth. As detailed below, the present outlook for this is not particularly encouraging. The banking sector is limited in its present geographic coverage and scope of lending, and the two leading, government-controlled institutions are virtually crippled with financial and management problems. An increasing portion of banking credit has been taken by the government and parastatal enterprises in recent years, and this situation is not likely to change in the medium term, thus, restricting the amount of credit which will be available to the private sector. In addition, there is great uncertainty associated with the creditworthiness and volume of potential new

179

demand from the private sector. Finally, the current framework of UMOA financial sector regulations provides inadequate financial incentives for greater initiatives and risk-taking on the part of the banks. These constraints must be resolved if the financial sector is to play its critically needed role in the financing of Niger's development.

2. FINANCIAL SECTOR

a. Structure

Niger is a member of the West African Monetary Union (Union Monetaire Ouest-Africaine, UMOA), and shares a common currency, the CFA franc (pegged to the French Franc at the rate of FF 0.02 to FCFA 1.0) with the six other member states, and a common Central Bank, the Banque Centrale des Etats de l'Afrique de l'Ouest (BCEAO), located in Dakar, Senegal. Each country is represented through a National Credit Committee, the discretionary powers of which are limited.

Detailed information on the financial institutions is limited. The best current sources are World Bank reports on the Industrial Development Project (Cr. 1225-NIR), which is providing assistance to the BDRN, and the recent USAID-financed study, Rural Finance in Niger, carried out by Ohio State University (Feb 1987), which examines agricultural credit and CNCA and the informal financial sector in the rural areas. Two other complementary studies on the financial sector are in early stages of implementation with World Bank financing and are expected to be completed in late 1987, one on the banking sector and a second on investment and constraints to development of the private sector.

The formal financial sector consists of three development banks, six commercial banks, and three non-bank financial institutions. The development banks include: (i)the Banque de Developpement de la Republique du Niger (BDRN), 37% owned by government and the rest by a consortium of European Banks and private investors, is the dominant bank in the sector with approximately 44% of total banking sector assets, and 63% of total loans and 50% of private deposits; (ii)the Caisse Nationale de Credit Agricole (CNCA), 100% owned by government, does not take deposits and is the major channel of government and external donor financing of the agricultural sector; and (iii)the Credit du Niger (CN), about 45% owned by government, makes small loans mainly to public employees for real estate and equipment.

The six commercial banks have all been established since 1977. These include: (i)the Banque Internationale pour l'Afrique Occidentale (BIAO); (ii)the Banque Internationale pour le Commerce et l'Industrie du Niger (BICIN); (iii)the Banque Lybiene Nigerienne pour le Commerce Exterieur et le Developpement (BALINEX), 50% owned by the government; (iv) Citibank; (v) the Massraf Faycal Al Islami-Niger (MFIN); and (vi) the Banque de

180

Credit et de Commerce Internationale (BCCI). (Information on the relative market shares of these last two banks is not available.)

The banking sector is highly concentrated, both in terms of its geographical coverage and in terms of market control. There are a total of 27 bank offices in the country, and a third of these are in Niamey. Only three of the nine banks have five branches or more, with the BDRN accounting for 11, and CNCA and BIAO, five each. Lending is dominated by the development banks, about 75% of the loans outstanding are in the portfolios of BDRN (63%) and CNCA (12.5%). Three banks control about 96% of total private deposits, BDRN (50%), BIAO (30%) and BICIN (16.4%)

The non bank financial institutions are all government owned. These include: (i)the Caisse Nationale d'Epargne (CNE), a public savings institution which collects savings through the post office network, (ii) the Caisse de Prets aux Collectivites Terrritoriales (CPCT), which provides funds to the local governments, and (iii)the Fond d'Intervention en Faveur des Petites et Moyennes Entreprises Nigeriennes (FIPMEN) which channels government assistance (interest subsidies, loan guarantees, equity investments and services to small and medium-scale indigenous businesses in collaboration with the Office de Promotion de l'Entreprise Nigerienne (OPEN).

A UMOA inter bank money market was created in July 1975 to induce banks to maintain their excess reserves within the Union. Interest rates are set by the BCEAO and linked to the rediscount rate. Money market rates appear to offer banks a viable alternative to investing in higher risk priority sectors (OSU, p. 41).

There is an active and growing informal financial sector composed of a variety of group and individual financial services well integrated into the complex economy of the rural sector. Detailed and up-to-date information on this sector is provided in the Ohio State University study mentioned above. The major findings are briefly summarized below under the section on Savings and Credit in the Rural Areas.

b. Financial Sector Regulations

The Nigerien financial sector is subject to the regulations as established by the UMOA and implemented by the BCEAO and the National Credit Committee. The principal instruments of BCEAO regulation of monetary and credit policy include: (i)the determination of global rediscount levels for each member country, (ii)enforcement of statutory limits on a government's share of domestic credit, (iii) interest rate regulation, and (iv)management of the inter-bank market. The National Credit Committee, chaired by the Minister of Finance, is responsible for distribution of the country's total credit ceilings among national and local government, banks, and the national treasury for rediscounting of customs bills and sectoral allocation of bank credit.

181

The BCEAO sets annual credit targets for individual countries based on a number of economic variables, including expected growth in GDP, prices and production trends, the balance of payments position, level of foreign reserves, and anticipated levels of net foreign assets. Excluded from annual credit ceilings are seasonal crop loans and financing of agricultural exports. Prior to the UMOA reforms of 1974, the BCEAO also set rediscount ceilings for individual banks and large-scale enterprises. Currently, the National Credit Committee determines the internal allocation of credit ceilings among financial institutions and sectors; however, according to UMOA statutes, individual banks are subject to rediscounting limits equal to 35% of their total assets, and government rediscounting is limited to 20% of the value of the previous year's recorded fiscal revenue. (We have no information on the implementation of this regulation or on the extent of bank and government use of the rediscounting facilities.)

The structure and level of lending rates are determined by the rediscount rates and bank margins on rediscounted credit mandated by the BCEAO. There are two levels of rediscount rates, those which apply to preferential lending (taux d'escompte preferentiel, TEP) and those applied to all other lending (taux d'escompte normal, TEN). Rates are adjusted periodically to align commercial lending rates with international rates (particularly those prevailing in France). Loans eligible for the TEP include lending for crop production, small- and medium-scale firms with less than FCFA 30 million of debt, and small-scale construction. As of 1985, the TEP was set at 8% and the TEN, at 10.5%. Bank margins range from 1% to 2% on seasonal agricultural and agricultural export credits, 1% to 3% on short-, medium- and long-term lending for domestic small and medium-scale firms and first home construction for UMOA residents, and 0% to 5% on all other non-preferential lending. In 1985, commercial bank lending rates were in the range of 9% to 10% p.a. for preferential loans and between 10.5 and 15.5 for all other loans. Real interest rates were in a positive range of 1.5% to 8% (using the GDP deflator). A schedule of interest rates in recent years is provided in the Annex, Table 2. The effective lending rate paid by borrowers depends on commissions and fees charged by banks and other taxes which may be levied on interest charges by the state. The BCEAO sets the maximum allowable commissions.

Minimum deposit rates are also regulated (see Annex, Table 3). Sight deposits under a minimum of FCFA 200,000 earn no interest; sight deposits above this amount were remunerated at between 3.5% and 4% until January 1985, when it was agreed by the UMOA to suspend a minimum interest obligation on all sight deposits for a period of two years. Currently, time deposits up to one year pay minimum rates of between 7.5% and 9.5%, depending on the maturity and size of the deposit. Savings deposits earn 8.5% and are subject to a maximum of FCFA 5 million for individuals in Niger.

182

Inter bank money market rates are set by the BCEAO and adjusted in accordance with the rediscount rates. A record of these rates in recent years is given in the Annex, Table 1.

The National Credit Committee determines sectoral lending priorities. In Niger, agriculture has the highest priority, followed by indigenous enterprises, industry and mining, construction, transport, and lastly, commerce. These priorities are implemented in an indirect fashion by the BCEAO through its application of the different rediscount rates for priority and non priority loans. The National Credit Committee exercises control on sector lending chiefly through the requirement that it approve all loans over an amount of CFAF 30 million. (We have no information on the detailed implementation on specific sector targets or the administration of these controls.)

Within the UMOA, the foreign reserves of the member countries are pooled in a common operating account managed by the BCEAO and linked to an unlimited overdraft facility with the French Treasury. France guarantees the convertibility of the FCFA into FF, and as of 1974, the purchasing power of the UMOA deposits in the operating account was also protected from excessive depreciation of the FF vis-a-vis the SDR through a mechanism in which the UMOA account was credited with the difference in the FF and SDR value of the reserves. A number of rules govern the use of foreign exchange in the member countries: (i)capital transfers to countries outside the franc zone require prior approval of the Ministry of Finance; (ii)imports from non franc zone countries also require Ministry of Finance approval; (iii)foreign exchange proceeds from exports to non-franc zone countries must be collected within 120 days of arrival at destination; (iv)charges are levied on all transfers from outside or within the franc zone, ranging from 0.10% per FCFA million on transfers into or within the franc zone to 2.5% per million on transfers out of the franc zone.

c. Performance of the Banking Sector

The banking sector is in a phase of contraction and recession. Prior to 1984 and the drought, total assets and liabilities had already declined substantially in the period 1980 to 1983, by about 40% in nominal terms. Trends in the composition of assets and liabilities during this period reveal a number of worrisome indicators (OSU, pp. 47-49). On the liabilities' side is the decline in the proportion of private deposits, from 34% in 1980 to 25.4% in 1984, and in government deposits from 13.3% to 8%. These losses were offset by more expensive sources of funds, foreign borrowings which increased from 21.5% in 1980 to 28% in 1983 and central bank liabilities from 10% to 17%. On the asset side, credit to non government entities fell from about 65.5% in 1980 to about 55.4% in 1983. This figure warrants further clarification since credit to parastatal enterprises is included in the "non government" category; and, in fact, loans to the parastatal sector increased three fold during this period (see Annex, Table 6). On top of

183

this, credit to the government increased from 7.7% of total assets in 1980 to 12.2% in 1983. In 1984, many of the banks reported operating losses. This was due, in large part to drought and closing of the Nigerian border which increased loan failures, but also to the rising financial costs of bank resources as private depositors withdrew funds and the government changed from being a net provider of funds to the banking system to a major debtor.

d. Development Banks

The development banks, BDRN and CNCA, are largely responsible for the apparent structural deterioration in the banking sector. Their poor performance during this period stems from a combination of factors, including: (i)institutional weaknesses, in large part inherent in the organizational objectives and structure; (ii)their dependence on public funds and their special role in financing the parastatal sector; and (iii)the generally poor quality of their loan portfolios reflected in crippling arrears and high bad debt provisions.

BDRN

Details of the BDRN's performance and problems are given in World Bank reports on the Industrial Development Credit Project and in supporting documents for the IDA Parastatal Enterprise Reform Support Program Credit for Niger approved in 1986. The external audit report of BDRN's 1982/83 financial year revealed an unsustainable deterioration in financial performance: a critical arrears situation, including indications of "political" loan making -- overdues of FCFA 8 billion owed by eighty of the 100 largest clients of the bank; a growing government debt of FCFA 16 billion; and the need for a major injection of new capital, estimated by the auditors at FCFA 5.4 billion, to cover operating losses and increased bad debt provisions. On the basis of this report, the World Bank and government launched a major rehabilitation program in 1984, which was later linked to the IDA Structural Adjustment Credit of 1986. The principal elements of this program include: (i)a major effort to reduce arrears, (ii)an immediate capital increase, and (iii)technical assistance from a foreign bank to reorganize and improve management and efficiency.

The audit report of 1984/85 showed marginal improvement in an otherwise dismal picture of the institution and the general economy. The report indicated that the investment climate was so poor that "no bankable project [i.e., eligible for IDA refinancing] has been presented to BDRN in two years." The overall quality of the loan portfolio remained poor; bad debt provisions on the non governmental portion (including parastatal enterprises which are not defined as government borrowings) were estimated at 40% of the outstanding loan amount of FCFA 82.7 billion, or FCFA 25.4 billion. Government borrowings represented FCFA 27 billion (no provision is made for government debt, because it is considered fully secured). The net result of the

184

year was a loss of about FCFA 1 billion, nevertheless an improvement over losses of FCFA 10.4 billion in the previous year.

CNCA

The case of the CNCA, documented in the Ohio State University study, is not unlike that of other specialized agricultural credit institutions established by governments in many developing countries to channel subsidized credit to selected target groups. Its structure and management do not foster the necessary conditions for responsible loan operations or long-term institutional viability. CNCA takes no deposits and is financed entirely by government, donor funds, and central bank rediscounting facilities. It serves essentially as a conduit of public resources to largely externally financed rural development projects and other parastatal enterprises involved in agricultural services. As such, CNCA retains virtually no control over loan appraisal, monitoring or collection; while the credit intermediaries have little financial incentive to apply creditworthiness criteria in loanee selection or to enforce collection.

The progressive deterioration of the financial position of CNCA over the period 1979/80 to 1983/84 is clearly revealed by the following selected statistics provided from the OSU team's financial analysis. The total loan portfolio shrank from about FCFA 17 in 1982/83 million to about FCFA 15 million in 1984/85, reflecting mainly (i)the decision to halt all new loans to delinquent borrowers, (ii)the drying up of new funds as external donors sought other ways to channel credit to farmers, and (iii)the slow turnover of funds available for new lending. The quality of the loan portfolio declined substantially; CNCA accounts show an increase in bad debt provisions on the portfolio from about 2.5% to 8.5% over the period 1982/83 to 1984/85; even this is a gross underestimate, due to the fact that provisions are not made for loans to parastatal enterprises and the government. CNCA's profitability was increasingly squeezed during this period between an increase in the average charges on borrowings as a percentage of average financial assets from about 6% in 1979/80 to almost 10% in 1982/83 (a correction to 6.3% in 1983/84) and a diminishing return on financial assets from 2.4% in 1979/80 to only 1.2% in 1983/84.

These adverse developments undercut the viability of the institution as shown by the huge drop in the net profit from financial operations from 21% in 1980 to 9.8% in 1984 and similarly, a fall in the net return on capital and reserves from 14.4% to 7.9% in this same period. Finally, the increasing instability of the institution is illustrated by the decline in the capital/asset ratio from about 20% in 1979 to 12.5% in 1983 (improvement in 1984 to about 16%) and the serious erosion of the bank's capital and reserves as a percentage of total assets from about 19% in 1979 to 12.5% in 1983, with a correction

to about 16% in 1984. On the basis of this poor performance and major institutional deficiencies, the OSU team has recommended that the CNCA be abolished and that other formal and informal sector financial intermediaries be identified and developed to provide financial services in the rural areas (OSU, pp97-100).

e. Analysis of Total Bank Lending to the Non Government Sectors

The distribution of consolidated banking sector credit to the private sector and parastatal enterprises is given in the Annex, Table 6. Total lending to these sectors increased by about 50% in nominal terms between 1979 and the end of 1983; this represents, however, only a marginal increase of less than 2% p.a. in real terms (using the GDP deflator).

Analysis of the geographic distribution of private sector credit was not possible on the basis of information available. Only three banks have branches outside the capital city, i.e. BDRN, CNCA and BIAO, and it is unlikely that other banks have any significant volume of business beyond Niamey. The OSU field survey of rural credit showed that household access to institutional credit is very limited. It was estimated that about 22% of households had obtained some kind of institutional loan in the 5-year period preceding the survey (i.e. 1980-84) (OSU, p.145). Most of these loans were provided by CNCA, largely through cooperatives, development projects and other parastatal intermediaries. Given the progressive deterioration of CNCA, this incidence of institutional credit support for rural households has certainly dwindled to negligible amounts at the present time. According to the OSU study, most wholesale and some retail traders, however, had regular access to commercial bank loans. This suggests that the geographic distribution of loans for at least some types of businesses is much better than for others.

In terms of the composition of lending, a number of salient features and trends are to be noted. First, short-term lending (less than one year) predominates, representing 83% of total lending in 1983, compared to 14.5% for medium-term lending (2 to 3 years) and 2.5% for long-term lending (generally in the range of 3 to 5 years). The proportion of short-term lending increased from about 72% in 1978 at the expense of medium-term lending which accounted for more than a quarter of total lending (27%) in 1978. Second, lending to government's "priority" sectors declined from 1978 to 1983. Loans to the rural sector (agriculture, forestry and fishing), the first priority for government, accounted for a minute and decreasing portion of total lending, 6.4% in 1978 and only 4% in 1983. Loans to mining and industry combined reached 30% of total lending in 1980 and then fell sharply to 21% in 1983. Despite being the lowest of government's lending priorities, commercial activities accounted for about 47% of total lending in 1983; this percentage jumped from an average of about 36% over the period 1978-82, reflecting a sharp drop in banks' willingness to lend for riskier production

186

activities. The third significant trend is the increase in the share of total non government credit to parastatal enterprises, from 22.6% in 1978 to 34% in 1980 and 31% in 1983. In 1983, parastatals claimed about 30% of short-term credit, 29% of medium-term credit, and 57% of long-term credit.

In conclusion, the general economic decline which began in the late 1970s and became acute in the first half of the 1980s had a profound impact on the banking sector. Private sector and government deposits in the banking system dropped from a combined 47% to 33% of total banking system liabilities between 1980 and 1983. Government "crowding out" of the private sector became more pronounced in 1981-82, when the government became a net borrower in the financial system. Total non governmental lending, excluding parastatal enterprise lending, actually decreased slightly in real terms between 1980 and the end of 1983. The deteriorating performance of the development banks, BDRN and CNCA, led the decline in the financial sector, although other private commercial banks suffered from the recession and reported losses in 1984. The impact of economic recession is mirrored in: (i)a dramatic increase (about 75% in both 1983 and 1984) in the banking sector's overall provisions for bad debts and (ii) increasing conservatism in lending activities, notably, the increasing proportion of short-term lending and concentration of this lending in low risk activities of commerce and transportation to the detriment of the government's priority investment areas, the rural sector, industry, and mining.

f. Savings and Credit in the Rural Areas

In the rural areas, savings and credit needs of the population are met through a combination of formal and informal sector arrangements (this section summarizes findings of the Ohio State University team). On the savings side, the Caisse Nationale d'Epargne (CNE) is the most important of the institutional services used by rural households; other informal arrangements include group savings in cooperatives, small mutual savings and credit associations called "tontines," or village "moneykeepers." On the credit side, access to institutional credit is limited to larger businesses serving the rural sector (traders and input suppliers appear to have regular access to commercial bank credit) and to a small subsector of the higher per capita income households. The most common sources of informal household assistance are relatives, friends and neighbors, and traders and merchants.

The potential for savings in the rural areas is limited. The OSU field survey results showed that only 13.6% of all households had operational surpluses from the preceding year's activities. Most of the households, however, had temporary or seasonal surpluses. Permanent surpluses were more likely to be saved in the form of deposits; whereas temporary surpluses were likely to be used as short-term assistance for relatives and friends.

157

The CNE has been successful in providing deposit services for those with higher and more stable levels of excess liquidity. The CNE was established in 1970 and uses the 42 branches and 8 mobile units of the Office des Postes et Telecommunications (OPT) to collect these savings. Since 1971, the number of private accounts has increased five-fold, to about 51,600 in 1984. Total year-end deposit balances over this same period have increased from about FCFA 110 million (an average balance of FCFA 9,402) to FCFA 992 million (average balance, FCFA 19,232). Interest rates on deposits are 7.5% p.a.; the effective rate is lower because interest is accrued only beginning the first or sixteenth day of the month. Not unexpectedly, the annual growth in the number of accounts and outstanding balances has decreased since 1980. Total withdrawals were higher than total deposits, however, has not been accompanied by a loss in the perceived integrity of the service, since the number of deposit transactions since 1980 has been consistently larger than the number of withdrawal transactions.

Of other, informal savings arrangements, the mutual savings and credit "tontines" and the local "moneykeeper" are the best known. The tontine is typically a local group of friends or persons of similar activities, such as artisans, and can vary in size from a few to several dozen persons (OSU survey showed a range of 4 to 40). Members of the group agree to a fixed weekly contribution, and members are given the chance to borrow these resources on a rotating basis. The average loan size recorded among those interviewed by OSU was FCFA 39,342 (US$104). This is an equitable system geared to the consumption loan needs of members; repayment performance is generally excellent. Such mutual saving and credit societies are found in many developing countries. The village moneykeeper is generally a respected member of the community and often active in local trade, since he also often serves as an intermediary to procure or sell goods outside the village. Among the 56 moneykeepers surveyed by OSU, the number of depositors and deposit levels fluctuated seasonally; at the height of the rainy season, the 39 moneykeepers who were active year around held total deposits of about FCFA 30 million (US$79,000) or an average deposit of CFAF 48,774 (US$128). This declined in the dry season to a total of CFAF 13 million, or an average deposit of FCFA 35,507 (US$115). It is noted that the average dry season deposit is much higher than the average CNE deposit in 1984 (FCFA 19,200) (OSU p 252). Most of the village moneylenders (78% of those survey) also provide short, 1 to 3 month, loans for consumption purposes to other members of the village community. Interest rates are not paid on deposits and reliable information is not available on the level of remuneration paid by borrowers.

With low levels of family income and high seasonality to rural production activities, short-term borrowing or assistance is a necessity for most families. Access to institutional sources is very limited; the OSU survey team estimated that about 22% of households obtained a loan in an average year, the average loan value was about FCFA 15,916, equivalent to about 10% of the

188

average annual agricultural income for the a family (OSU, p.156). Not surprisingly, the typical CNCA borrower was found to have a higher level of per capita income, larger family and higher literacy than the average rural household.

Informal borrowing is much more extensive, and it would appear that the value of the assistance is higher than that of the average institutional loan. The OSU field survey showed that 86% of heads of households and/or spouses received some kind of assistance from at least one source in the previous year. The most common sources of assistance were, by order of importance, relatives, others (presumably associations and moneylenders) friends and neighbors, and traders. The predominant forms of assistance were grains and cash. The average value of this informal assistance was about FCFA 31,000, or about 20% of the yearly agricultural income of a rural household. According to this study, about 66% of households surveyed indicated that they provided assistance to others during the previous year. The OSU study also pointed out the positive correlation between receiving formal sector loans and participation in informal loan activities. One explanation offered is that the increased liquidity provided by formal sector loans may enhance the ability of the household to provide assistance to others (OSU,p.170), although certainly other economic factors (e.g. the higher relative income of the loanee) and social considerations (e.g. greater community obligations of the higher income households and those receiving "outside" assistance) play an important role in the lending behavior of formal loan recipients.

In summary, the OSU study of rural finance identifies the existence of a number of key elements upon which further development of efficient financial intermediation can be built. First, there is a sizable liquidity base and demand for a variety of savings and credit services. Second, the rural community has developed savings habits and experience with short-term loans and other forms of assistance; the repayment record on informal borrowings is good and enforced through personal ties and social cohesion of the lender and borrower community. Third, there is a close interrelationship at the local level between saving, lending and borrowing necessary to the understanding and practice of viable financial services (OSU, p.270).

The OSU study recommended that a cooperative credit union movement be developed to build on the strengths of the informal financial system: "It is important to recognize that a savings and credit cooperative can broaden the financial base of activity into a larger membership than can the numerous but smaller tontines and money-keepers. This larger membership implies a wider base for savings mobilization as well as a more extensive range for its loan clientele, thus gaining greater scale economies in its operations as well as a more diversified portfolio at the village level. In the end it represents a more efficient form of financial intermediation than that occurring in the array of separate, segmented markets of smaller tontines and money-keepers." (OSU, p. 354) In their recommendations, the OSU

team also points to the overriding importance of maintaining features critical to the success of the present, informal arrangements, particularly (i)local management and participation of the villagers in the credit management process to ensure local confidence in the new system, (ii)provision of saving services and use of savings as collateral for loan demands; and (iii) provision of consumption loans, among other types of credit needs. A three-year plan of action to establish these village savings and credit unions is outlined in the OSU report.

3. CONCLUSIONS

The macroeconomic policies being pursued within the framework of the UMOA regulations and structural adjustment reform program have been successful in stabilizing major imbalances in the Nigerien economy. However, there are several areas where current practice falls short of reform objectives or where regulations are likely to impede desired strengthening of the financial sector. In addition, there are other broader constraints to effective structural reform and sustainable economic development which will continue to limit the potential role of the financial sector in contributing to development.

Among the major structural problems is the continued government "crowding out" of the private sector through both direct loans to the government and indirect financing of the parastatal enterprises. Resolution of this problem will require continued efforts to reduce the government deficit and to divest and/or improve the efficiency of the parastatal sector. Therefore, it is unrealistic to expect permanent improvement in credit allocation to the private sector in the medium-term future.

The serious financial and management problems of the development banks pose a major threat of instability for the financial system. Top priority should be given to the BDRN reform program being supported by the World Bank under the Parastatal Enterprise Reform Support Credit. The problems of the CNCA are largely inherent in the present institutional structure of agricultural credit and prevent CNCA from becoming a viable and self-sustaining financial institution. CNCA should be disbanded and viable elements of its portfolio transferred to another lending institution. Alternative financial intermediaries should be identified and/or established to cater to the savings and credit needs of the rural community. The OSU report recommends the prudent development of a credit union movement; French assistance is also being provided to review other alternatives.

The present structure of interest rates as established by the UMOA is contributing to the contraction of the financial system, by providing inadequate financial incentives for bank lending to certain sectors and weakening the financial viability of the banking institutions. Although lending rates are generally positive in real terms at current inflation levels,

190

savings rates are negative except on the largest of long-term deposits. Private sector deposits declined in the banking system as a whole during the period 1983-85, and, together with the loss of public sector deposits, caused a tightening of liquidity and forced the banks to turn to higher cost resources, including rediscounting with the BCEAO and foreign borrowings. Given the increased cost of borrowing and the high risks associated with loans to the productive sectors (private and parastatal), banking margins mandated by the BCEAO are wholly insufficient to induce banks to finance the priority sectors for development.

The distribution of outstanding credit suggests that selective credit controls have not been effective in changing the patterns of bank lending. Given the generally higher risks of investments in the priority lending areas, forcing banks to comply with targets might result in a further deterioration of the banks' portfolio performance. Consideration should be given to alternative measures to induce greater bank lending in these areas; increasing interest rates and margins for high-risk and term lending would serve such a purpose.

In addition, the climate for private sector investment needs to be improved before banks will increase their lending. A study has recently been launched with World Bank financing to examine this issue in detail. Among the constraints which need to be addressed are: (i)the effect of continued government price and marketing controls in certain areas; (ii)the pace of government divestment and the potential for the private sector to respond to new business opportunities in these areas; and (iii)the structure of incentives for private business, indigenous and foreign, as reflected in the tax system, trade regime, and investment code.

Other structural weaknesses: (i) uncertain investment potential in productive sectors; (ii)need to realign budgetary expenditures with high priority sectors, agriculture and industry; and (iii)continuing shortage of trained manpower needed to upgrade public sector management and fill positions in the private sector, including financial and non-financial institutions.

INFORMATION GAPS AND AREAS FOR FURTHER FIELD RESEARCH

- Extent of bank and government use of BCEAO rediscount facility in recent years;
- Administration of selective credit controls;
- Details on banking sector regulations regarding minimum capitalization levels, liquidity requirements, bad debt provisions and other safety ratios;
- Reporting requirements of financial institutions and BCEAO inspection capacity and quality;
- Details on savings mobilization by the banks;
- Activity of the Nigerien banks in the UMOA money market;

191

BIBLIOGRAPHY

AID, "Country Development Strategy Statement - FY 1988", Manuscript (Washington, D.C.:1986)

AID, "Niger Action Plan, FY 1987-88", Manuscript (Washington, D.C.: 1986)

AID, "Country Development Strategy Statement", Manuscript (Washington, D.C.: 1986)

Greve, Albert, "Commercial Banks and Rural Credit in Niger: a Case Study in Private Sector ...", Manuscript (Washington, D.C.: 1987)

IBRD, "Report and Recommendations on a Proposed African Facility Credit to the Republic of Niger", Manuscript (Washington, D.C.: 1986)

IBRD, "Niger: Policy Framework Paper, 1987-89", Manuscript (Washington, D.C.: 1986)

Laurent, M., "Mid-term Evaluation of the USAID/Niger Agricultural Sector Development Grant", Manuscript (Washington, D.C.:1986)

Ohio State University, "Rural Finance in Niger: a Critical Appraisal and Recommendations for Change", manuscript (Washington, D.C.:1987)

192.

Niger Annex
Table I

Niger: National Income Indicators, 1978-85

	1978	1979	1980	1981	1982	1983	1984	1985
Gross Domestic Product (billions of CFA francs)								
Rural Sector	166.1	188.7	228.1	269.3	299.5	311.5	268.2	332.1
Agriculture	87.3	96.5	120.8	154.0	156.6	159.7	153.1	207.5
Livestock	61.4	72.2	89.0	104.1	120.8	128.0	92.7	100.0
Forest & Fish.	17.4	20.0	18.4	20.2	22.1	23.8	22.4	24.6
Mining	37.0	63.1	67.4	52.0	49.8	55.5	53.6	59.3
Indust & Energy	16.4	19.4	22.2	27.0	32.4	36.9	35.7	38.5
Construction & Public Works	17.1	24.5	32.1	26.6	24.8	23.9	19.2	23.7
Commerce, Transport & Services	84.1	103.2	125.5	147.6	159.1	169.0	161.9	171.6
Government	22.8	25.1	33.8	39.6	45.8	49.8	52.8	54.9
GDP at Factor Cost	343.5	424.1	509.1	562.1	611.4	646.6	591.4	680.1
Import Taxes & Duties	15.5	19.1	27.1	27.8	31.3	28.0	24.0	25.0
GDP at Current Market Prices	359.1	443.2	536.2	589.9	642.7	674.6	615.4	705.1
GDP at Constant 1976 Prices	268.2	307.6	327.0	323.9	321.4	313.0	262.7	280.1
Implicit GDP Deflator(1976=100)	132.9	144.1	164.0	182.1	199.9	215.5	234.3	251.3
Annual Growth Rates (percent)								
Real GDP	7.2	14.7	6.3	-0.9	-0.8	-2.6	-16.1	6.6
Real GDP/capita	4.5	11.1	3.6	-3.7	-3.5	-5.3	-18.9	3.8
GDP Deflator	16.0	7.4	13.8	11.0	9.8	7.8	8.7	7.5

Sources: Toh (1986), IMF, International Financial Statistics (198), and OSU, p.24.

Niger Annex
Niger: Table 2

BCEAO Regulations and Lending Rates, 1982 - 1985

Line of Credit	Regulation		Range of Loan Rates %	
	Rediscount rate %	Margin %	1982-1984	1985-present
Short and Medium-Term Loans				
Seasonal crop financing and agr. exports	TEP[a]	1 - 2	11 - 12	9 - 10
Small and medium-sized domestic firms with overall outstanding debt less than CFA F 30 million	TEP	1 - 3	11 - 13	9 - 11
First home construction for UMOA residents, loans less than CFA F 1.5 million	TEP	1 - 3	11 - 13	9 - 11
Other short and medium-term	TEN[b]	0 - 5	12.5 - 17.5	10.5 - 15.5
Long-Term Loans				
Small and medium-sized domestic firms with overall outstanding debt less than CFA F 30 million, and residual maturity less than 10 years	TEP	1 - 3	11 - 13	9 - 11
First home construction for UMOA residents, less than CFA F 1.5 million and residual maturity less than 10 years	TEP	1 - 3	11 - 13	9 - 11
Other long-term	TEN	0 - 5	12.5 - 17.5	10.5 - 15.5
Overall Range			11 - 17.5	9 - 15.5

Source: BCEAO; OSU, p.40

[a] TEP: Preferential rediscount rate ("taux d'escompte préférentiel"), see text.
[b] TEN: Normal rediscount rate ("taux d'escompte normal"), see text.

194

Niger Annex
Niger: Table 3

Interest-Rate Regulations on Private Deposits

Type of Deposit	Size of Account CFA francs							
	Up to 200,000		200,001 to 500,000		500,001 to 2,000,000		more than 2,000,000	
	1982 -1984	1985	1982 -1984	1985	1982 -1984	1985	1982 -1984	1985
	%		%		%		%	
Demand Deposits[a]	0	0	4.5 fixed	--	5.0 fixed	--	5.0 min.	—
Time Deposits								
Less than 6 months	7.25 fixed	6.25 fixed	7.75 fixed	6.75 fixed	8.25 fixed	7.25 fixed	8.25 min.	7.25 min.
6 months to less than 1 year	8.25 fixed	7.25 fixed	8.75 fixed	7.75 fixed	9.50 fixed	8.50 fixed	9.50 min.	8.50 min.
1 year or more	9.25 min.	8.25 min.	10.00 min.	9.00 min.	10.50 min.	9.50 min.	10.50 min.	9.50 min.
Savings Deposits	9.50	8.50 (Maximum size of account established by each member country. In Niger: 5 million CFA for individuals).						

Source: BCEAO; OSU, p. 42

[a] Obligation to pay interest on demand deposits was suspended for two years, starting January 1985.

Niger Annex
Table 4

Average Annual Interest Rates in the Money Market, 1975 - 1985

Year	Overnight Deposits %	Overnight Advances %	One-month Deposits %	One-month Advances %	Three-month Deposits %	Three-month Advances %
1975	7.000	7.123	--	--	--	--
1976	6.875	7.125	--	--	--	--
1977	7.000	7.250	--	--	--	--
1978	7.250	7.500	7.063	7.313	7.125	7.375
1979	6.938	7.188	7.063	7.313	7.313	7.563
1980	10.250	10.531	10.375	10.625	10.625	10.875
1981	14.500	14.813	14.625	14.875	14.875	15.125
1982	14.000	14.333	14.125	14.375	14.375	14.625
1983	11.500	11.813	11.625	12.875	11.875	12.125
1984	11.125	11.406	11.250	11.500	11.800	11.750
1985	10.625	10.875	10.750	11.000	11.000	11.250

Source: Toh (1986); OSU, p.44

Niger Annex
Table 5

Niger: Composition of Assets and Liabilities of the Banking System, 1980 - 1983

	Year			
	1980 %	1981 %	1982 %	1983 %
A. Assets				
Reserves	2.83	3.73	2.46	3.46
Foreign Loans	3.98	2.61	1.61	3.46
Credit to Government	7.76	11.26	12.69	12.17
Credit to Non-government	65.47	59.18	57.63	57.38
Other Assets	20.88	23.16	25.55	23.52
Total Assets	100.00	100.00	100.00	100.00
B. Liabilities				
Private Sector Deposits	34.00	34.42	24.96	25.41
Government Deposits	13.27	10.13	8.19	7.79
Central Bank Credit	10.07	13.27	16.44	16.96
Foreign Liabilities	21.40	16.88	28.01	27.75
Permanent Funds	9.62	8.83	8.89	9.11
Other Liabilities	11.63	16.41	13.50	12.93
Total Liabilities	100.00	100.00	100.00	100.00

Source: Ministère du Plan, Bulletin de Statistique (1984); OSU, p.50

Niger Annex
Table 6

Niger: Distribution of Credit to Non-government Sectors, 1979 - 1983.
End-of-Period Balances in Millions of CFA Francs

Term / sector	Year 1978	1979	1980	1981	1982	1983
Short-term						
Rural[a]	2327	3244	3084	3488	5844	3740
Mining	2780	3947	4101	1565	3823	4007
Industry	3001	4636	8733	8094	11692	9627
Construction	4027	4560	8445	12603	11892	13420
Transport	2501	3690	5498	6491	6902	7368
Commerce	16335	24418	25910	28856	36106	44802
Services	204	1502	1959	1234	1199	1289
Financial Inst.	399	-	-	-	-	-
Other	2588	10	-	-	-	-
Total short-term	34612	46007	57730	62331	77458	83533
of which, public & semi-public enterp.	8099	13779	18560	22259	27793	25272
Medium-term						
Rural	734	1010	1392	2299	2506	326
Mining	6649	8470	5251	6572	5029	2907
Industry	1156	4305	5469	5627	6000	5273
Construction	1607	2750	3034	3390	2625	1437
Transport	910	1723	1772	1482	1040	938
Commerce	789	852	1636	2142	2494	2519
Services	241	678	730	917	1053	1062
Financial Inst.	15	-	-	-	-	-
Other	724	-	-	-	-	-
Total medium-term	12825	19788	19284	22429	20747	14462
of which, public & semi-public enterp.	2451	5719	7019	7223	7340	4233
Long-term[b]						
Industry	56	47	-	-	-	-
Construction	25	-	-	-	-	-
Transport	173	-	1058	1487	1568	1428
Commerce	-	783	25	25	20	15
Services	29	155	310	274	1095	1119
Total long-term	283	985	1393	1786	2694	2562
of which, public & semi-public enterp.	222	817	1090	1506	1583	1458
Total Credit	47720	66780	78407	86546	100899	100557
of which, public & semi-public enterp.	10772	20315	26669	30988	36716	30963

Source: Ministère du Plan, Bulletin de Statistique (various issues); DSU, p.54
[a] Agriculture, Forestry and Fishing. [b] Sectors without long-term credit excluded

THE WEFA GROUP

OCT 13, 1987

NIGER

MACROECONOMIC VARIABLES

	80	81	82	83	84	85	86
GROSS NATIONAL PRODUCT, MILL US$	2369.6	2142.2	1873.9	1699.7	1369.0	1537.6	NA
GNP PER CAPITA, US$	447.1	389.5	334.6	293.1	232.0	252.1	NA
EXPORTS, FOB, MILL US$	565.7	454.8	332.1	597.8	NA	NA	NA
CURRENT ACCT. BAL., MILL US$	-275.7	-181.5	-232.8	-81.9	-24.0	-57.2	NA
TOTAL EXTERNAL DEBT, MILL US$	703.6	908.4	837.0	814.2	833.0	989.8	NA
CONSUMER INFLATION, 1980=100	100.0	122.9	137.2	133.8	145.0	143.7	139.1
US$/FRANC, PERIOD AVERAGE	0.005	0.004	0.003	0.003	0.002	0.002	0.003
POPULATION, MILL.	5.3	5.5	5.6	5.8	5.9	6.1	NA

MONETARY SURVEY

	80	81	82	83	84	85	86
MONEY SUPPLY, M2, BILL. FRANCS	77.9	94.1	83.0	82.7	101.0	108.1	NA
CONSUMER INFLATION, 1980=100	100.0	122.9	137.2	133.8	145.0	143.7	139.1
WHOLESALE PRICE INDEX,1980=100	NA	NA	NA	NA	NA	NA	NA
DISCOUNT RATE	10.5	10.5	12.5	10.5	10.5	10.5	9.5
COMMERCIAL PRIME RATE	NA	NA	NA	NA	NA	NA	NA
GOVT. BOND YIELD, MEDIUM TERM	NA	NA	NA	NA	NA	NA	NA
DEGREE OF MONETIZATION	NA	NA	NA	NA	NA	NA	NA

NIGER

CONSOLIDATED BALANCE SHEET OF
DEPOSIT MONEY BANKS
BILLION FRANCS

ASSETS	80	81	82	83	84	85	86
RESERVES	3.8	6.3	4.7	6.8	17.7	24.9	NA
FOREIGN ASSETS	4.0	4.4	3.0	6.8	4.8	2.4	NA
CLAIMS ON GOVT.	10.4	19.0	23.7	23.9	23.4	21.7	NA
CLAIMS ON PRIVATE SECTOR	87.3	99.3	107.0	112.2	97.7	88.2	NA
LIABILITIES							
DEMAND DEPOSITS	32.3	38.8	34.5	33.8	45.9	45.6	NA
TIME AND SAVINGS DEPOSITS	13.3	19.3	12.1	16.1	22.6	27.5	NA
FOREIGN LIABILITIES	19.2	12.0	32.3	26.4	21.7	16.6	NA
GOVT. DEPOSITS	17.8	17.1	15.3	15.3	17.4	19.1	NA
CREDIT FROM CENTRAL BANK	13.5	22.4	30.7	37.3	20.9	20.6	NA
CAPITAL ACCOUNTS	NA	NA	NA	NA	NA	NA	NA
VALUATION ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
OTHER ITEMS, NET	0.6	3.5	-5.9	-2.8	-12.8	-18.8	NA

BALANCE SHEET OF CENTRAL BANK

ASSETS	80	81	82	83	84	85	86
FOREIGN ASSETS	28.4	30.3	10.0	22.2	42.5	51.6	NA
CLAIMS ON GOVT.	10.9	12.2	15.9	27.9	31.1	38.9	NA
CLAIMS ON OFFICIAL ENTITIES	NA	NA	NA	NA	NA	NA	NA
CLAIMS ON COMM. BANKS	NA	NA	NA	NA	NA	NA	NA
CLAIMS ON SPECIAL BANKS	13.5	22.3	30.7	33.3	20.8	20.3	NA
LIABILITIES							
RESERVE MONEY	34.8	41.1	41.7	38.3	48.7	58.3	NA
OF WHICH							
CURRENCY OUTSIDE BANKS	31.1	34.8	35.3	31.5	30.7	33.4	NA
QUASI-MONEY DEPOSITS	NA	NA	NA	NA	NA	NA	NA
FOREIGN LIABILITIES	4.5	4.1	4.7	21.2	26.6	35.6	NA
CAPITAL ACCOUNTS	NA	NA	NA	NA	NA	NA	NA
RESCHEDULING ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
VALUATION ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
OTHER ITEMS, NET	2.8	3.1	3.4	4.1	2.5	0.4	NA

NIGER

GOVERNMENT FINANCE
BILLION FRANCS

	80	81	82	83	84	85	86
DEFICIT(-)/SURPLUS(+)	-25.2	NA	NA	NA	NA	NA	NA
REVENUE	77.4	NA	NA	NA	NA	NA	NA
EXPENDITURE	98.7	NA	NA	NA	NA	NA	NA
FINANCING							
DOMESTIC	8.2	NA	NA	NA	NA	NA	NA
FOREIGN	21.6	NA	NA	NA	NA	NA	NA

INTERNATIONAL DEBT
MILL. US$

	80	81	82	83	84	85	86
TOTAL EXTERNAL DEBT, (EDT)							
LONG-TERM DEBT	703.6	908.4	837.0	814.2	833.0	989.8	NA
PUBLIC AND PUBLICALLY GUARANTEED	398.9	605.0	603.2	632.6	671.0	791.3	NA
PRIVATE NONGUARANTEED	304.7	303.4	233.8	181.6	162.0	198.5	NA
USE OF IMF CREDIT	0.0	0.0	0.0	32.3	44.3	66.7	NA
SHORT-TERM	159.0	113.0	123.0	65.0	61.0	98.0	NA
TOTAL LONG-TERM DEBT							
DEBT OUTSTANDING AND DISBURSED	703.6	908.4	837.0	814.2	833.0	989.8	NA
DISBURSEMENTS	176.8	285.3	115.6	127.9	72.8	75.1	NA
PRINCIPAL REPAYMENTS	22.8	29.3	66.7	36.9	33.2	36.7	NA
NET FLOWS	154.0	256.0	48.9	91.0	39.6	38.4	NA
INTEREST PAYMENTS	16.1	33.8	44.5	36.3	25.0	30.3	NA
NET TRANSFERS	137.9	222.2	4.4	54.7	14.6	8.1	NA
TOTAL DEBT SERVICE	38.9	63.1	111.2	73.2	58.2	67.0	NA
PRINCIPAL RATIOS							
TOTAL EXTERNAL DEBT							
EDT/XGS)	134.0	224.6	261.7	246.0	308.7	460.7	NA
EDT/GNP)	36.4	47.7	51.2	53.6	68.5	75.1	NA
INTERNATIONAL RESERVES	132.4	109.7	34.7	57.4	92.1	140.0	NA

F. RWANDA

1. MACROECONOMIC SURVEY

a. Introduction and Discussion of Key Problems

Despite its small size and highly limited natural and human capital resources, Rwanda has maintained one of the highest growth rates in Africa, an average of 6% p.a., in the period since Independence in 1962. This is due to a number of positive factors, including most notably: (i)success in expanding smallholder coffee and plantation tea sectors (its major exports), coupled with relatively favorable world prices throughout most of this period(and for coffee, an acceptable quota position in the International Coffee Organization and opportunities to sell surpluses in non-quota markets in some years), (ii) the spontaneous intensification of subsistence agriculture, and (iii) political stability and conservative macroeconomic management. In the 1970s, Rwanda also benefitted from large amounts of foreign development assistance to finance extensive investments in social and economic infrastructure and the "coffee boom" of 1977, which contributed to small government budget surpluses in a number of years, balance of payments surpluses in the late 70s, and a manageable external debt service ratio (9.5% in 1985).

The strong growth of the 1970s was temporarily reversed in the early 1980s, when terms of trade declined dramatically by 35% over 1980-81 and remained at 1980 levels through 1983. The small government budget surplus in 1980 (0.9% of GDP) was eroded by these events and the deficit climbed to a high of 2.5% of GDP in 1983. In parallel, the overall balance of payments position plummeted from a positive position in 1980-81 to a negative position in 1982 and 1983. GDP growth fell from 5.8% in 1980 to a level of about 2.5% in 1983. Faced with this decline, the government introduced austerity measures in late 1983, cutting expenditures and freezing a number of non critical imports. These measures, together with a substantial improvement in the terms of trade in 1984, helped to achieve reductions in the fiscal deficit (to 1.5% of GDP in 1984 and 1.8% in 1985) and the overall balance of payments position, which regained a positive footing in 1984. General economic recovery, however, was stalled by a drought in 1984 (GDP growth was negative by 4.3%), but began to pick up again in 1985, with an increase of 5% in real terms, and an estimated 4.2% real growth rate in 1986.

Evolution of the money supply, credit allocation, and the net foreign asset position since 1980 reflect changes in the government budget position, since the government is heavily dependent on the banking system for domestic financing. As Table 1 in the Annex indicates, growth in broad money over this period ranged from 10% to 17% (reflecting high growth in quasi-money at about 21% p.a. in comparison to narrow money, which grew at an average of only 6% p.a.), with the exception of 1982, when broad money growth was only 1.4%, the result of an approximate 30%

decrease in net foreign assets and a doubling of domestic inflation in that year to 12.6% which depressed savings. During the early 1980s, the government became a net borrower in the system; claims on government rose by 7.5% in 1981 and again by 16.7% in 1983; with recovery of export receipts in 1984, government returned to being a marginal creditor in 1984 and 1985. Credit to the private sector was sharply reduced in the crisis years and grew by only about 2% p.a. in 1982 and 1983, recovering again in 1984. Credit to public enterprises increased sharply over this period, from a level of 2.2% of total domestic credit in 1980 to 3.8% as of March 1985, reflecting increased subsidies to this poorly performing sector. Inflation, as measured by the CPI, has remained relatively low since 1980, with the exception of 1982, when the impact of the recession was its greatest. Since 1982, inflation has been steadily reduced to a level of 1.7% in 1985, and reportedly even lower in 1986. (IBRD, CEM, October, 1986, p. 17)

In 1985, Rwanda had a population of about 5.5 million people with a population growth rate of between 3.8% and 4% p.a., one of the highest in the world. It is estimated that 20% live in the capital, Kigali, and two or three other fast-growing secondary towns. GNP per capita is among the lowest in the world, equivalent to US$270 in 1984. The agricultural sector accounts for about 43% of GDP (at factor cost), commerce, 17%, manufacturing, 15%, public administration, 13%, mining, less than 1%, and other sectors, 11%. Export earnings are highly dependent upon the coffee and tea sectors, which represented an average of 62.8% and 11.6%, respectively, of export receipts over the period 1980-85; mineral exports (casserite, tin and wolfram) contributed another 17.3% over this period.

The government administration in Rwanda has remained small in comparison to many other African countries; however, where possible, government has kept a tight reign on the economy and has pursued a fairly "directed," if not interventionist role in many sectors. A clear example of this is government's efforts to regiment agricultural production and anti-erosion control in many parts of the country. Another example is its heavy investment in parastatal enterprises: there are 20 parastatals wholly owned by government and another 20 with some government equity participation. In other areas, such as price control, government's attempts at more direct control over the economy have been limited largely due to insufficient means of enforcement.

b. Medium-term Development Objectives

Although Rwanda regained general economic stability following the plunge in coffee prices in the early 1980s and the drought in 1984, there is a broad consensus in government and the donor community that the Rwandan economy remains highly vulnerable to external factors and that the domestic sources of previous growth are increasingly limited and being overtaken by high population growth rates. The most critical factors limiting

future growth include: (i) increasing land scarcity and over cultivation, resulting in declining agricultural yields; (ii) the lack, to date, of improved agricultural technology adapted to the Rwandan context; (iii) diminishing returns in the mining sector and the recent collapse of SOMIRWA, the parastatal mining company; (iv)the small size of the manufactuting sector and continued dependence on imported materials as well as consumer goods, (v)critical shortages of trained manpower, affecting both the private and public sectors; vi)the weakness of rural service and market-oriented institutions, and vi) low levels of income and the small size of the domestic market.

In recognition of these factors and the fragility of the economy, the government announced a Program of Economic Recovery in 1985, focussing attention on the need for structural adjustments to sustain the recovery and to spur new growth. The reform program emphasized the need for improvement in the industrial incentive system; strengthening of public resource management; reorganization and some divestment in the public enterprise sector; rehabilitation of the mining sector; and concentration of rural and agricultural sector investments on development of critical technologies (i.e. through agricultural research) and service delivery (e.g. for inputs, farmer extension, etc).

These objectives are strongly supported by the donor community; special policy reform assistance has been approved by the World Bank (through recent industrial and agricultural sector projects and a technical assistance program for the Ministry of Finance) and USAID (through the Policy Reform Initiatives in Manufacturing and Employment Project (PRIME), financed as part of the AEPRP program). However, these efforts constitute only the initial stage of policy reform and are largely aimed at refining the basic problems and developing the details of appropriate structural adjustments, training government personnel, and, particularly in agriculture, reinforcing research and testing new systems of service delivery. The actual implementation of the specific structural adjustment reforms will be carried out over the next two to five years. Thus, the ultimate ability of the government to carry through these reforms and the potential impact of such measures on the economy have yet to be determined.

The implication of recent trends and the proposed reform programs for the financial sector are far reaching, particularly in light of the relatively limited and conservative role that the sector has played to date in the financing of development. While the adjustment process is being launched on the basis of a fairly even economic footing (i.e. low government deficit, good balance of payments position, low level of external debt burden), the cost of the proposed reforms in the short, and possibly in the medium term, are likely to fall heavily on government. This will imply new levels of government borrowing from the banking system. In addition, there is still a high degree of uncertainty about the capacity of the small domestic manufacturing sector to sustain phased removal of current high levels of protection, and

204

about the potential responsiveness of both indigenous entrepreneurs and foreign investors to proposed new investment incentives. The ability of the existing businesses to make adjustments and of new ventures to get off the ground will depend on the capacity and willingness of the financial sector to undertake a significant amount of refinancing and to extend term loans and equity capital to start up ventures. These demands represent a significant challenge to the financial sector and will require changes in traditional conservative lending practices, adjustments in the regulatory framework and the development of strong parallel support in the form of business advisory services and initial loan guarantee programs.

2. FINANCIAL SECTOR

a. Structure

The financial sector consists of a central bank, the Banque Nationale du Rwanda(BNR), five banking institutions, two non deposit taking financial institutions, two insurance funds and the national social security fund. Detailed information on the financial sector is provided in two recent studies financed under the USAID PRIME project: (i)Financial Sector Review of Rwanda, carried out by Development Alternatives, Inc. (under the Employment and Policy Analysis Project implemented by Harvard University and Michigan State University) and submitted in January 1987 and (ii) The Market Analysis and Project Design for An Equity Participation Fund for the Republic of Rwanda, executed by the International Science and Technology Institute and the Equator Advisory Service, Ltd, and submitted in November 1986 (draft). In this study, we have drawn heavily from these two sources, and support, in particular, the observations and many of the recommendations of the Development Alternatives (DAI) study.

The banking sector institutions in Rwanda include three commercial banks: the Banque Commerciale du Rwanda (BCR), the Banque de Kigali (BK), Banque Continentale Africaine (BACAR); a national savings and loan institution, the Caisse d'Epargne du Rwanda (CER); and a formal association of rural cooperative savings and loan institutions, the Banques Populaires (BP). In addition, there is a government and donor-funded development bank, the Banque Rwandaise de Developpement (BRD) and a public sector housing mortgage bank, the Caisse Hypothecaire du Rwanda (CHR). Selected features of these institutions are summarized in Table 2.

Several important characteristics of the financial sector should be noted.

First, the government is a significant shareholder in all of the institutions except the BACAR and the BP. In the case of the BP, management has been heavily supported by the Swiss external aid program, coupled with annual operating subsidies (on a declining basis) from government, and infrastructure in the local

districts, or "communes," has been financed from local taxes and built through the mandatory public labor commitment ("Umaganda") of the local community. Both the factor of substantial government ownership and the factor of high visibility and "public responsibility" within the small official community in Rwanda result in a high degree of government influence in the business and financial community.

Second, the commercial banks account for 76% of all lending activity and hold approximately 70% to 80% of all deposits (a detailed breakdown of deposit holding by institution is not available).

Third, with the exception of the rural savings and credit institutions, which have an extensive branch network (BP had 84 branches in 1985 and are aiming at one in each of the 143 communes by 1990; the CER has 60 branches), there is little presence of the financial institutions outside the capital. The commercial banks are located in Kigali and one or two of the larger secondary towns; and the non deposit banks are located only in the capital.

Fourth, there is a high degree of institutional specialization.

-BCR and BK have a relatively diverse portfolio, although mainly in short-term lending and heavily concentrated in commerce and urban-based operations, and international trade transactions.
-BACAR, recently established, is apparently attempting to carve out a significant share of the medium-term lending and to cater to the larger borrowers.
-The Caisse d'Epargne, like similar institutions in many other African countries (e.g. Zaire and Niger), was originally established to mobilize public savings in the rural areas for investment mainly in public infrastructure projects, and to a lesser extent, housing. It has deviated substantially from this purpose and finances mainly housing, commerce and current operations in the tea sector. High non repayment and management inefficiency has resulted in serious financial problems.
-The Banques Populaires are rapidly replacing the CER as the major rural savings institute. This is both a reflection of the deteriorating services and performance of the CER as well as other attractive features of the BP, convenience, cooperative ownership and strong management which has gained the confidence of the rural community, and increased access to consumer and small investment loans. The BP invest two-thirds of their deposits in commercial bank deposits and government development bonds, the other third in diverse rural activities, mainly commerce and housing, although increasingly in agricultural and livestock production and small consumer loans.

-The BRD was set up as a development bank to provide long-term debt and equity financing for the productive sectors and is financed largely through external donors. The extent of its equity financing has been quite limited; it has taken equity positions in only 14 companies since 1968. Beginning in 1982, it launched a special program to finance small and medium-scale businesses which the commercial banks have been reticent to finance.
-The Caisse Hypothecaire, which raises its funds principally through the issuance of housing bonds, is involved only in housing loans.

b. Semi-formal and Informal Financial Sector

While there are growing number of production and market oriented cooperatives, there is no tradition of savings and credit societies as we have found in a number of other African countries. As concerns informal sector moneykeepers or money lenders, we have seen no information leading us to believe that this is developed to any recognizable extent. The success of the Banques Populaire in recent years suggests that there is a need for basic financial services in the rural areas and potential for financial intermediation.

In sum, the structure of the financial sector presents some potential problems for future development and innovation, as well as some promising prospects. The major problems are (i)in the heavy concentration of deposits and lending activity in Kigali and in two traditional commercial banks (BCR and BK); (ii)the large degree of government ownership interest, which, except in the case of BDR, has not yet been fully exercised to force the banks into developmental lending, (iii) the high degree of specialization, which diminishes healthy competition, and (iv) the impending collapse of the CER and the CHS. On the positive side, (i) the recent entry of BACAR seems to have introduced a new degree of competition among the commercial banks, and (ii) in the rural areas, the BP are providing basic services to an important and neglected portion of the market. They have a critical role to play in mobilizing rural savings, educating rural households about credit, and extending badly needed consumption and investment loans to a segment of the population that cannot meet minimum loan size or collateral requirements of the commercial banks.

c. Financial Sector Regulation

The central bank, BNR, is responsible for the implementation of national monetary and credit policy, management of foreign reserves and all foreign exchange transactions, and regulation of the deposit banks. The principal instruments of central bank control and sector management are the following: (i) credit ceilings for individual bank lending which control total term

207

lending and credit allocation to non-priority sectors, (ii) fixed interest rates on deposits and different types of lending, (iii) central bank refinancing facilities and (iv) regulations pertaining to bank financial structure, reserves and other provisions and other aspects of lending policy. Credit controls, interest rates, and BNR rediscounting facilities are discussed below; regulations on other banking practices are not examined here, but are detailed in the DAI study. Banking sector regulations are increasingly being employed to direct more lending to the priority sectors. While there continues to be a prudent concern for financial stability, embodied in the limitations on "risk exposure" or term lending, debt financing restrictions and other safety ratios; credit ceilings and, to a lesser extent, prior authorizations and refinancing facilities are being implemented in such a way to coax the banks into financing development objectives.

The BRD sets an annual, global ceiling on domestic credit expansion on the basis of GDP growth projections, Government financing needs among other macroeconomic considerations. This global ceiling is then allocated to individual banks on the basis of a formula which takes into consideration their net worth and deposit base (term deposits are weighted at 200% and sight deposits at 40%). Increasingly, other factors, such as the bank's record on lending in priority areas, are being taken into account in the allocative process (DAI, p.18). Individual bank credit ceilings act only as a limit on bank lending in non priority areas, and there is a stiff penalty for exceeding the ceiling. The list of priority lending activities not subject to the credit ceilings has been expanded since 1979, when only coffee sector financing and loans to the communes were exempt. Currently, the priority list includes a broad range of activities, from most productive investments in the rural areas to agricultural marketing, international transport (because of Rwanda's landlocked position, transport costs add a minimum of 30% to the f.o.b. price), employment generation and educational loans, and first-home construction. Bank lending to these activities requires prior approval of the BDZ, but this is virtually automatic.

Analysis of bank compliance with credit ceilings and the amount of lending outside the ceilings to priority sectors is provided in Table 3(DAI study, pp. 18-22). This shows that (i) on the whole, banks have complied with credit ceilings and (ii) in 1985, credit to non priority lending represented about 49% of total lending, with about 33% of the ex ceiling lending (51% of total) in coffee sector financing.

The Central Bank also attempts to limit the funding risks of bank term lending by setting ceilings on a bank's total medium and long-term lending. This ceiling is calculated on the basis of a formula that assigns relatively high weights to net worth and deposits over one year and takes into account a bank's funding commitments to fixed assets, doubtful loans and equity investments. Central Bank approval is required to exceed these

208

ceilings. While time deposits have represented an increasing portion of total private sector deposits in recent years (from 28% in 1980 to 47% in 1984), the majority of term deposits are still of maturities less than one year. Thus, term-lending is currently constrained by the short-maturity structure of bank resources. In 1985, three of the five deposit banks exceeded the original ceilings (see Table 4). The composition of the term lending of these banks indicates that, with the exception of the BACAR and BCR, actual medium and long-term loans to the private sector was significantly below the original ceiling, and the differential between medium and long-term lending and actual approved levels has been invested largely in government development bonds. This is not surprising given the relatively attractive interest rates earned on these low risk instruments (Treasury bonds of 6 to 12 month maturities earn 7.5% to 8.0% p.a. and Development bonds with maturities ranging from 2 to 5 years earn between 8.75% and 10.25%).

Thus, up to the present, the government has encouraged the banks to allocate an important portion of their term-lending capacity to investment in government securities, in essence accepting bank reticence to become involved in term lending to the private sector and providing for the extension of the public sector in financing development. This runs contrary to the objectives of (i) growth and innovation in the financial sector, and (ii) increasing the role of the private sector in development and may result in disintermediation to the extent that government development bonds are used to finance recurrent expenditures.

The structure and level of interest rates on bank deposits and lending is fixed by the Central Bank, and has remained unchanged now since November 1979 (Table 5). It should be noted that deposit rates in this table are post-tax and reflect a 20% tax on interest that banks are required to pay to individual deposit holders; banks are not subject to the same tax on interest paid to businesses (DAI, p 23). The non deposit banks (BDR and CHR) are not subject to these lending rate restrictions, nor are the Banques Populaires or the ailing Caisse d'Epargne, which have been granted exemptions.

Commercial bank time deposits (up to one year) for individuals range from 6% p.a. (post-tax) on 1-month deposits on minimum deposits of FRW 50,000 (US$500) to 7% p.a. on 6-month deposits, and certificates of deposit on 6-month to five-year savings bonds earn interest in a range of 6.75% to 9.5% p.a. (post-tax). Sight deposits earn no interest. Interest rates on time deposits were marginal or negative in real terms over most of the period 1979-83 (and highly negative in 1982, when inflation jumped briefly to 12.6%); however, since 1984, real rates have been in positive (in the range of 4.3% to 5.4% in 1985, when inflation dropped to 1.7%). Deposit rates currently charged by the CER are 6% p.a. (i.e. positive). Passbook savings rates paid by the BP are 3% p.a. (i.e. positive since 1984). These high positive rates explain the large growth in time deposits in recent years. Growth in high-cost deposits is also

209

increasing pressure on the financial institutions to expand lending and other investments.

The structure of commercial bank interest rates on loans is highly stratified, both by the nature of the activity and the loan term (see also Table 5). Rates on financing of different activities within the coffee, tea and mining sectors, and for exports and import financing, are specifically defined. Short-term loans for priority sector operations range from about 8% to 10% on an annualized basis; interest rates on other, non priority short-term loans are 14% p.a. Medium- and long-term loans to priority sectors are set at 11% maximum, whereas non priority term lending bears an interest rate of 14% p.a. on medium-term loans (1-5 years) and 14.5% p.a. minimum on longer-term loans. Real interest rates are currently highly positive, in a range of about 7% to 15%.

Interest rates charged by the financial institutions not subject to the fixed-rate schedule are not significantly different from those charged by the commercial banks, reflecting the fact that they are largely government controlled. For example, the lending rates of the Banques Populaires range from 8% to 13% p.a., with rates on short-term consumption loans (usually 6 to 9 month loans) at 8% to 9% p.a., medium-term loans (1 to 3 years) for agricultural and rural production in the range of 9% to 12% p.a., and transportation, housing and commercial loans in the range of 12% to 13% p.a. The BRD, which does mainly medium- and long-term lending, charges 12.5% p.a. on priority sector loans (agriculture, livestock, and industry) and 13.5% p.a. on other loans.

In sum, the interest rates on deposits and loans have been set to benefit the savers and priority sector borrowers. The structure and level of rates have remained rigid and unchanged since 1979, despite fluctuations in inflation. Among the weaknesses of this policy are: (i) the non remuneration of sight deposits and relatively high minimum term deposit requirements which discourage the small saver -- a large percentage of the market; (ii) insufficient term differentiation of deposit rates, which limits mobilization of longer-term savings; and (iii) the large difference between the implied interest margin on priority lending (3% to 5%) and non-priority lending (3% to 8%), which gives banks little incentive to expand lending in the priority areas.

The BNR offers several types of refinancing options for the deposit banks, including: (i) rediscounting of commercial paper and promissory notes on a short-term basis, (ii) advances for high volume short-term lending activities, such as the purchasing of the coffee crop which takes place within a 2 to 3 month period each year, and (iii) some refinancing of high-priority, medium-term development loans. Rediscount rates applicable to these types of commercial bank transactions range from 3.5% to 9% p.a. The amount of credit rediscounted by the banks has increased dramatically in recent years, and more than tripled

40

between 1980 and the end of 1984. In 1984, credit from the BNR represented about 7% of total deposit bank liabilities. Based on recent trends in use of rediscounting facilities and the maintenance of low rediscount rates, it would appear that the intention of this policy has been mainly to ease banking sector liquidity and secondly, to provide incentives for increased lending to government and development projects.

At present, the standards of accounting and auditing in Rwanda are extremely low. This affects the capacity of the Central Bank to monitor the financial sector, and is also a serious problem for the financial management of the banking sector and other entities in the public and private sector. External auditing of the financial institutions is typically carried out by national accountants appointed by the board of directors of the financial institution; in cases where the institution has received funding from international agencies (World Bank, in particular), The financial institution has been audited by an internationally recognized auditing firm. Central bank monitoring of financial institutions is currently carried out by insufficiently trained staff on the basis of monthly financial statements submitted by these institutions. It is clear that this level of supervision is inadequate and should be a priority for technical assistance and training.

d. Financial Sector Lending

An analysis of lending by the financial institutions in for the most recent two years is provided in detail in the DAI study and key data are summarized in the Tables 6 to 8. Unfortunately, we do not have time series data and are, thus, unable to determine whether there have been any significant changes in the present patterns. The essential features as of December 1985 are as follows:

(i) The three commercial banks together account for about 76% of total lending; most of their lending is short-term (83%), medium-term loans represented about 13% of commercial bank loans, and long-term loans, only 4% -- mainly for the financing of vehicles; these banks account for 91% of total short-term lending, 65% of medium-term lending, and 17% of long-term lending.

(ii) The BDR does 70% of all long-term lending, and the CER and the CHR together account for about 10% of long-term loans.

(iii) In terms of sectoral distribution of lending, the agricultural sector receives about 38% of total credit (86% of this is short term), with agro-industry (coffee and tea, in particular) accounting for over 90% of agricultural lending; the commercial sector ranks receives about 22.5% of total credit (more than 70% of this short term); and the industrial sector receives about 16.5% of total credit (75% short-term and 23% long-term).

011

(iv) The average loan size in the sector as a whole is relatively small, between FRW 1 and 2 million (US$ 11,765 and 23,530), and three-fourths of all loans are under FRW 5 million (US$ 58,823). There is an enormous difference in the average size loan granted by the different financial institutions, a general indication of the stratification of the market. The BRD, at the higher end of the market, has an average loan size of about FRW 5.7 million(US$ 67,000) and the BP, at the lower end, has an average loan of about FRW59,000 (US$650).

Other Special Institutions to Promote Financial Intermediation

The Special Guarantee Fund. In order to promote greater bank lending of indigenous small- and medium-scale businesses, the BNR established the Special Guarantee Fund (FSG) in 1978. It is financed by a 10% levy on pre-tax earnings of all financial institutions and a 3% charge on the amount of principal guaranteed (80% of the project cost). The maximum guarantee for individuals is FRW 5 million, and for companies, FRW 10 million; this can be applied to loans from any of the financial institutions. In principle, the fund can guarantee up to five times its capital; as of the end of 1985, total capital was FRW 217 million, but only FRW 100 million in guarantees had been granted. The FSG has been fully operational only since 1985, when its legal statutes were finally approved and a core staff and management appointed. In 1985, the fund guaranteed about 100 loans. It is too early to judge the performance of the fund, but this is an interesting experiment that warrants the practical support of the banks and the external donors.

Business Promotions. Two projects have recently been approved to assist in the identification and development of bankable small and medium-scale businesses and to provide training, technical assistance and studies geared to the needs of indigenous entrepreneurs. These projects include: (i) the USAID-financed Private Enterprise Development Project(1984-88), which has established a business advisory office in Kigali, and (ii) the World Bank financed Gitarama Rural Services Project (1985-88), which is based in one of the regional capitals. The USAID project, for which we have recent supervision reports, has been actively assisting urban entrepreneurs to carry out feasibility studies and in providing management and accounting skills. In their reports, the project staff has emphasized a number of critical limitations to development of the private industrial sector in Rwanda, including: (i) the limited surpluses generated by the agricultural sector, (ii) high transportation costs within the country; (iii) extensive involvement of the parastatals in most potentially profitable areas of the economy (overcapacity, high costs and weak management are making the parastatals unprofitable, whereas smaller, more localized and more efficient businesses could be profitable); (iv) the shortage of basic management skills in the country, and (v) low purchasing power of the population. These findings underscore the both the limited extent of bankable projects and the riskiness of

investment in the secondary sector, and the constraints, other than financing, to future growth and development of the country.

e. Financial Performance

To varying degrees, all of the financial institutions are experiencing financial difficulties. In general, declining performance reflects recent economic conditions; however, certain institutions face problems which are inherent in their financial structure, management weaknesses or in the underlying institutional mandate.

The three commercial banks are still considered to be quite profitable compared to the rest of the financial sector, although two of the banks, BCR and BK, have seen their pre-tax earnings to equity ratio decline dramatically since 1982. In BDR's case, this ratio declined from 60 in 1982 to 12 in 1985; for BK, the drop was from 50 to 10. This seems attributable mainly to the collapse of the mining company, SOMIRWA, which was heavily indebted to these two banks and to the BRD. The BACAR, which is newer, and therefore, not as heavily burdened with parastatal debt, is doing comparatively well, with a pre-tax return to equity on the order of 22% in 1985. Unlike most of the other financial institutions, the commercial banks have a measure of earnings protections from their diversified portfolio, strong involvement in international trade transactions (from which about 30% of their profits are derived), and a large spread (interest income on the portfolio ranges from 9% to 14% and average costs on resources is 3% to 5%). The major problems they face are their high administrative costs and vulnerability to increasing financial difficulties of the large-scale enterprise sector (including a high percentage of parastatals).

The Caisse D'Epargne and the Caisse Hypothecaire are both considered bankrupt at the present time. In 1985, accumulated losses of the CER had reached FRW 545 million, and the CHR was facing losses of FRW 90 million. These highly specialized institutions have suffered primarily from a collapse in the middle range housing market, which saw a big boom in the late 1970s and has since fallen apart due to economic recession and stagnant wages and salaries of the investing class -- largely civil servants. However, another major factor in their long-term unsustainability is the small spread with which they have to operate; the average cost of these institutions' funds is 6%, whereas they are restricted to charging only 9% on "social housing," a major part of their portfolios. Since neither of these institutions is expected to survive, the issue being considered by government is whether to create another lending institution to cater to special target groups (i.e. such as moderate and low income housing development) or to expect existing financial institutions to play a greater role in these areas.

23

The two development-oriented institutions, the Banques Populaires and the Banque Rwandaise de Developpement, are both struggling to become profitable. Both benefit from substantial spreads; the BP pay 3% on deposits and the BRD pays an average of 3.5% on concessionary external donor financing while loan charges range from 8% to 14%. However, both have high operating costs, which is to be expected from nature of their lending business, and both have a high percentage of loans in arrears, which can be reduced somewhat as their capacity for loan appraisal and supervision improves but which can be expected to remain higher than that of commercial banks. The operations of these two institutions are discussed in detail in the DAI study.

In the case of the BP, revenues from operations now cover about 95% of costs, subsidies from the government and the Swiss contribute help to cover the cost of the central management unit in Kigali. To date, its loan operations have remained conservatively restricted to one-third of the BP's resources, the excess being invested in bank deposits and government development bonds. This is probably wise given the high cost and high risk of its small loans, over half of which are to farmers, artisans and cooperatives and the high incidence of arrears, which currently affects about 50% of the loans outstanding. However, given these factors, it is questionable whether the BP can be fully self-supporting and profitable within the medium-term future.

In the case of the BRD, net profits have taken a plunge since 1982, from a level of FRW 73 million to FRW 12 million in 1985. This reflects, in part, the collapse of SOMIRWA, but also the high incidence of loans in arrears, 21%, many of which are loans to small- and medium-scale businesses since the inception of special efforts to promote this sector. The BRD has cut its lending to the SME in view of the poor performance of this part of its portfolio and its claim that there are few bankable SME projects. It is unclear at the present time what the source of BRD's lending will be in the medium term.

3. CONCLUSIONS AND RECOMMENDATIONS

a. Conclusions

Given its extremely limited natural, human, and financial resources and its high vulnerability to external factors (e.g. world coffee prices), it is indeed amazing that Rwanda has been able to maintain a high average annual growth rate of 6% over the last 20 years. The factors behind this relative success include: political stability and ethnic homogeneity, highly conservative macroeconomic management, successful agricultural intensification which has enabled output to grow faster than population, generally strong international prices for its major exports, and high, sustained levels of international support.

The constraints to sustaining real growth in the future are enormous, particularly in view of high population growth. In fact, the sources of future growth remain uncertain. High hopes are being placed on the reform of the industrial investment incentives, improvement in parastatal performance and partial privatization, and agricultural research and services; however, it would be unrealistic to expect significant results in any of these areas in the near term. The fundamental constraints to growth are (i) low agricultural productivity which translates into low incomes and purchasing power; this will not improve unless new, high yielding technologies can be identified and introduced rapidly and at low cost, and (ii) low educational and skills levels, which limits the capacity for reform and innovation in the public and private sectors.

While reform in the financial sector is necessary in order to improve the financial health of certain institutions and to introduce greater incentives for development lending, the potential impact of such reforms on overall growth of the economy will depend on the degree to which underlying constraints to growth, mentioned above, can be alleviated. As such, it is our judgment that financial sector problems are not the key, or even major, obstacles to growth in Rwanda.

b. Recommendations

Financial sector policy in Rwanda should have four main objectives: (i) to rationalize sector regulation to reduce unnecessary bureaucracy and enhance meaningful monitoring of safety and stability, (ii) to strengthen viable lending institutions, (iii) to increase savings mobilization, and (iv) to provide incentives for greater development lending. In addition, parallel efforts are required (v) to improve financial skills in the banking community, as well as in the government and private sectors, and (vi) to promote private sector investment through practical assistance projects. The following are suggestions for financial sector reform to achieve these principal objectives.

-Rationalization of Credit Ceilings. The current system of credit ceilings and controls, with day-to-day involvement of the BNR in credit decisions, is unnecessarily complicated. To the extent that implementation of national credit growth ceilings requires an explicit allocation of credit to individual financial institutions, this should be done of the basis of an institution's record and capacity for efficient financial intermediation (i.e. considering both its demonstrated ability for increasing its deposit base and effectively using these resources for short- and long-term lending). In addition, the BNR should communicate to the financial institutions the full amount of their credit allocation and replace ceiling restrictions on non priority lending with other incentives to promote priority lending, such as improving financial margins on loans to priority sectors and providing attractive rediscounting facilities for such priority lending.

20

The government's policy on Treasury bills and Development bonds should be reviewed to ensure that financial institutions capable of greater term investment in the productive sectors do not substitute investment in these instruments for direct development lending.

-Introduction of Greater Interest Rate Flexibility. The structure and level of interest rates has remained unchanged since 1979, despite fluctuations in inflation. The current rate structure favors depositors and priority borrowers, but does little to improve mobilization of term savings or to stimulate higher investment in priority areas. In addition, given present low levels of inflation, interest rates are being held unnecessarily high, discouraging investment. Greater flexibility should be allowed to provide for (i) increased differentiation of savings rates, including a minimum rate for sight deposits and more spread between short (less than one year) and longer-term deposits; (ii) higher bank margins on riskier and longer-term priority lending activities; and (iii) periodic adjustments to take account of inflation.

-Financial Sector Supervision. The Central Bank's ability to monitor policy implementation and the safety and soundness of financial institutions needs to be strengthened. This should be addressed through (i) the review and improvement of financial reporting requirements; (ii) training of BNR and bank accounting staff, and (iii) refinement of appropriate monitoring indicators and reinforcement of presently weak inspection procedures.

-Critical Evaluation of the Future of CER and CHR. A full audit and detailed review of the management, portfolio, and other operations of these troubled institutions should be carried out to determine whether they can and should be revitalized or phased out. In the meantime, the government should impose moratorium on the raising of new resources by these institutions and new lending activities and appoint a special outside team to concentrate of collection of outstanding arrears.

-Reinforcement of Key Development Lending Institutions. Special efforts must be made to strengthen the financial position and institutional capacity of both the Banques Populaires and the BRD. The Banques Populaires are still a long way from becoming financially self-sustaining. They will require continued technical assistance and operational subsidies for at least the medium term. They should not be forced to expand their lending activities faster than they develop a field capacity to appraise loans and improve collection mechanisms and performance. The BRD's financial position needs to be strengthened in order to maintain its ability to finance new, productive businesses. Recent deterioration appears to be the result of overextension in the SME sector and pressure to bail out troubled parastatal enterprises. The BRD also needs to concentrate on consolidating its portfolio, reinforcing collections and rescheduling repayment where required. Further measures should be taken to strengthen

216

staff capacity for loan appraisal and monitoring and early intervention and assistance in investment projects when trouble is detected.

-The Special Guarantee Fund is an important feature of government's policy to promote development lending. Effective use of this fund will require stringent application of creditworthiness standards to prospective guarantees and full enforcement of legal remedies to collect on loan arrears or default. The government should be prepared to provide management and staff training to insure that this program is expertly managed. In addition, the Fund should be audited on an annual basis by an internationally accepted auditing firm.

c. Information Gaps and Areas of Further Study

-Detailed information is needed on the structure and sources of deposits and the scope for mobilization of greater term savings

-Follow-up studies on the lending operations of the Banques Populaires and the procedures (and their application) for loan appraisal, disbursement, and loan collection

-Loan collection methods of different financial institutions and the availability and enforcement of legal remedies for non repayment

-Follow-up study on the implementation of special business promotion projects to determine potential for new investment

217

Table 2: Selected Data on Major Financial Institutions(1985)

Financial Institution	Date est.	Govt. ownshp. %	Total Assets (FRW bill)	% Total Lending %
Comm. Banks:				
BCR	1960s	51	9.5	35.5
BK	1960s	50	8.2	28.5
BACAR	1983	4	3.5	12.0
Rural S&C:				
BP	1976	N.A	1.5	4.5
CER	1963	100	N.A.	6.0
Non-deposit banks:				
BRD	1968	55	3.5	12.8
CHR	1975	62	3.1	0.5

Source: IBRD; DAI Financial Sector Review

218

BIBLIOGRAPHY

AID, "Country Development Strategy Statement, FY 1988", Manuscript (Washington, D.C.: 1986)

AID, "Country Development Strategy Statement", Manuscript (Washington, D.C.: 1987)

Arthur Young, "Summary of Financial Markets Survey", Manuscript (Washington D.C.: 1986)

IBRD, "Rwanda: Recent Economic Developments and Current Policy Issues", Manuscript (Washington, D.C.: 1986)

Rwanda Table 1

Table Monetary Survey
(Change in percent of broad money stock at the beginning of the period)

	1981	1982	1983	1984	1985
Foreign assets (net)	0.6	-25.5	-11.0	9.4	-3.1
Domestic credit	19.3	18.4	23.1	8.9	15.1
Claims on Govt (net)	7.5	14.0	16.7	-0.5	-0.9
Credit to private sector	10.9	1.9	2.0	10.6	15.8
Credit to public enterprises	0.5	0.9	2.7	-0.8	-0.1
Broad money	12.4	1.4	11.8	10.1	17.2
Narrow money 1/	7.3	-2.4	7.4	8.4	9.3
Quasi-money 1/	32.0	11.9	22.2	13.7	33.3

1/ Annual growth rate.

Source: IBRD, p.16

220

Table 2: Selected Data on Major Financial Institutions(1985)

Financial Institution	Date est.	Govt. ownshp. %	Total Assets (FRW bill)	% Total Lending %
Comm. Banks:				
BCR	1960s	51	9.5	35.5
BK	1960s	50	8.2	28.5
BACAR	1983	4	3.5	12.0
Rural S&C:				
BP	1976	N.A	1.5	4.5
CER	1963	100	N.A.	6.0
Non-deposit banks:				
BRD	1968	55	3.5	12.8
CHR	1975	62	3.1	0.5

Source: IBRD; DAI Financial Sector Review

Rwanda Table 3

BANK LENDING COMPARED TO BNR GLOBAL CEILINGS
(in millions of RFW, end of period figures)

Credit	BNR Ceiling Authorized	BNR Ceiling Actual	Coffee Outside	Other Ceiling	Total
BCR					
1984	2,004	2,066	1,606	733	4,405
1985	2,284	2,345	2,183	962	5,490
6/30/86	2,345	2,285	2,748	777	5,810
BK					
1984	1,823	1,561	1,091	791	3,443
1985	1,823	1,761	2,037	877	4,675
6/30/86	1,909	1,822	1,847	731	4,400
BACAR					
1984	500	674	272	138	1,084
1985	1,000	1,122	372	433	1,927
6/30/86	1,070	1,196	403	462	2,061
CER					
1984	1,033	900		325	1,225
1985	1,117	845	1	205	1,051
6/30/86	900	889	19	179	1,087
BP					
1984	700	556	15	55	626
1985	800	723	18	60	801
6/30/86	800	733	235	96	1,064
TOTAL					
1984	6,060	5,757	2,984	2,042	10,783
1985	7,024	6,796	4,611	2,537	13,944
6/30/86	7,024	6,925	5,252	2,245	14,422
CHANGE 1984/85					
- by amount	+964	+1,039	+1,627	+495	+3,161
- by percentage	+16	+18	+55	+24	+29
Breakdown of increase by type of credit		33	51	16	100

Source: DAI, p.20

Rwanda Table 4

BANK TERM INVESTMENTS COMPARED WITH BNR CEILING ON TERM LOANS
December 31, 1985
(in millions of RFW)

	BCR	BK	BACAR	CER	BP
(a) ORIGINAL CEILING	822	1067	639	185	1212
TERM LOANS, TREASURY AND DEVELOPMENT BONDS:					
Medium-term Loans	715	108	698	88	293
Long-term Loans	246	158	73	122	30
Treasury Bonds	200	79			
Development Bonds	1,050	645	300	0	190
(b) TOTAL	2,211	990	1,071	210	513
(a) - (b)	- 1,389	77	- 432	- 25	- 699

Source: Central Bank.

Source: DAI, p.21

783

Table 5

Rwanda: Structure of Interest Rates
(In percent per annum)

	Before Dec. 1979	Effective Dec. 11, 1979	Effective Dec. 1981
National Bank of Rwanda			
1. Direct operations with the private sector			
a. Export credits	6.0	6.0	6.0
b. Imports of equipment goods and other essential commodities	5.0	7.0	7.0
c. Other credits	7.0	9.0	9.0
d. Penalty rate on credit not repaid by maturity date	9.0	12.0	12.0
2. Operations with banks			
a. Advances against coffee paper at the processing stage	3.5	3.5	3.5
b. Advances against export paper (coffee, tea, and tin)	3.5	3.5	3.5
c. Coffee export paper above 25 percent of value	4.5	5.5	7.5
d. Advances against constituted export paper at the processing level	—	—	6.0
e. Advances against constituted export paper at the production level	—	—	7.0
f. Advances against Treasury bills	6.0	8.0	8.0
g. Rediscount of Treasury bills with one month of maturity and development bonds with 90 days of maturity	5.0	9.0	9.0
3. Operations with the Central Government			
a. Overdraft below 5 percent of the average of last three years' budgetary receipts	3.0	3.0	3.0
b. Overdraft between 5 and 10 percent of this average	4.5	4.5	4.5
c. Overdraft above 10 percent	6.0	6.0	6.0
d. Exceptional advance	3.0	3.0	3.0
Deposit money banks			
1. Deposit rates			
a. Term deposits 1/			
1 month	1.0	4.0	4.0
3 months	2.0	4.25	4.25
6 months	2.5	4.5	4.5
9 months	3.0	4.75	4.75
12 months	3.5	5.0	5.0
b. Savings bonds (certificates of deposit)			
6 months	3.0	4.75	4.75
9 months	3.5	5.0	5.0
12 months	4.25	5.0	5.75
2 years	—	6.0	6.0
3 years	—	6.5	6.5
4 years	—	7.0	7.0
5 years	—	7.5	7.5
2. Government bonds			
Treasury bonds (6-12 months	6.25-6.75	6.25-6.75	7.5-8.0
Development bonds			
2 years	7.5	7.5	8.75
3 years	8.0	8.0	9.25
4 years	8.5	8.5	9.75
5 years	9.0	9.0	10.25
3. Lending rates 2/			
a. Coffee financing			
Collection (5 months)	8.0	9.0	9.0
Processing (13 days)			
Storage (60 days)	} 2/ 3.0/kg	} 2/ 3.5/kg	} 2/ 4.0/kg
Exports (90 days)			
b. Tea and pyrethrum			
Storage (30 days)	8.0	—	—
Exports (120 to 180 days)	4.0	4.0	4.0
c. Mining operations			
Production/storage	—	3.0	9.0
Exports (120 to 180 days)	4.5	5.0	5.0
d. Other credit operations			
Imports of essential commodities (one year)	9.0	9.0	9.0
Construction under BF 4 million in cost	9.0	9.0	9.0
Other construction and current account advances (one year)	9.0	14.0	14.0
e. Investment approved by National Bank of Rwanda	...	11.0 max.	11.0 max.
f. Other credit with 1 years' maturity	9.0 - 11.0	14.0 min.	14.0
g. Other credit with maturity greater than 1 years	...	14.5 min.	14.5 min.
h. Penalty rate on loans that are not repaid on schedule 2/	= additional 2 percent during first 15 days of default = and additional 4 percent for delays beyond 15 days		

Source: Central Bank.

1/ Net of commissions.

2/ The interest rates on domestic that results after marks before disbursement are 0.75 percentage point higher than those on regular fixed term.

3/ A minimum charge of 0.75 percent is levied on all financial operations that require movements of installments.

4/ Introduced in 1980.

Source: DAI, p.24

224

Rwanda: Table 6

LOAN PORTFOLIO BREAKDOWN

BY TERM

(in millions of RWF)

December 85

Banks	Short	Medium	Long	Total
Banque Commerciale du Rwanda	4,465.5	741.8	262.2	5,469.5
Banque de Kigali	4,356.8	109.6	166.3	4,632.7
Banque Continentale	1,173.7	685.2	67.9	1,926.8
Banque Rwandaise de Développement	.1	16.9	2,070.1	2,087.1
Caisse d'Epargne	451.0	295.6	296.4	1,043.0
Banques Populaires du Rwanda	395.1	333.6	71.7	801.4
Caisse Hypothécaire du Rwanda	-	3.5	5.0	8.5
Banque Nationale du Rwanda	111.0	154.6	43.1	308.7
TOTAL	10,954.2	2,340.8	2,982.1	16,277.7

Source: DAI, p.32

225

Rwanda: Table 7

DISTRIBUTION OF LOANS BY ECONOMIC SECTOR
December 1985
(in millions of RWF)

Sector	Short	Medium	Long	Total	%	Letters of Credit	Guarantees
Agriculture and Livestock:	5,410	114	719	6,243	38	322	2
Ag. production: forestry, fishing, livestock	211	19	221	451		4	
Coffee	32			32			
Tea	0						
Skins	64			64		4	
Others	115	19	221	355			
Agro-Industry	5,199	95	498	5,792		318	2
Coffee	4,610			4,610		1	
Tea	589		90	679		24	
Others	0	95	408	503		294	2
Mining	3	3		6	0.1		
Industry:	1,994	45	637	2,676	16.4	702	82
Textile & leather Industries	13		249	261		26	
Chemical Industry	461	33	92	586		230	2
Mineral product & non-metal industries	2	12	51	65			
Metal industries	976		80	1,056			
Other industries	543		166	708		447	80
Gas & Electricity							
Buildings: Public works	511	11		521	3.2	227	996
Buildings	173	11		183		27	286
Public works	338			338		200	710
Commerce:	2,620	747	278	3,645	22.4	1,267	76
Petroleum products	232	30	52	314		671	6
Food	8			8		2	
Clothing	56	39	3	98		107	
Automobile purchase, maintenance & spare parts	360		91	451		1,146	3
Other	1,954	679	132	2,775		1,342	67
Services	57	147	409	613	3.8	174	61
Transport & inventory of goods							
Public transport	56	141	83	280		172	61
Hotels, restaurants Tourism	0	6	89	96			2
Other Services	0		237	237			
Other	360	1,275	940	2,575	15.8	5	3
Automobile purchase	62	371	8	441		5	
Purchase or improvement of housing	100	765	832	1,697			
Artisans	13	16		29			
Other	185	123	100	408			3
TOTAL	10,954	2,341	2982	16,278	100	4,697	1,219

Note: Short, medium, and long term loans are defined, respectively, as those up to one year, one to five years and over five years in term.

Source: DAI, p.10

226

Rwanda: Table 8

LOAN DISTRIBUTION BY SIZE AND TERM
June 30, 1986

AMOUNT (in 000s of RFW)	SHORT TERM	%	MEDIUM TERM	%	LONG TERM	%	TOTAL	%
Less than 500	157	16	20	4	17	4	55	3
500 to 1000	274	28	131	25	68	18	454	27
1000 to 2000	197	20	125	24	93	24	390	23
2000 to 5000	158	16	199	38	123	32	427	26
5000 to 10000	87	9	31	6	50	13	197	12
10000 to 15000	33	3	5	1	7	2	45	3
15000 to 20000	14	1	3	1	3	1	13	1
20000 to 50000	21	2	9	2	14	4	40	2
50000 to 100000	13	1	1	0	7	2	18	1
100000 to 200000	9	1	2	0	4	1	13	1
200000 to 300000	2	0	0	0	1	0	3	0
300000 to 400000	1	0	0	0	0	0	1	0
400000 to 500000	1	0	0	0	0	0	2	0
500000 to 1000000	0	0	0	0	0	0	2	0
1000000 to 200000	1	0	0	0	0	0	0	0
2000000 to 300000	0	0	0	0	0	0	0	0
More than 3000000	1	0	0	0	0	0	1	0
TOTAL	969	100	526	100	387	100	1661	100

Note: Includes only loans or lines of credit above RWF 500,000 disbursed by Rwandan bank and non-bank financial institutions.

Source: Central Bank.

Source: DAI, p.12

227

THE WEFA GROUP

RWANDA

OCT 13, 1987

MACROECONOMIC VARIABLES

	80	81	82	83	84	85	86
GROSS NATIONAL PRODUCT, MILL US$	1152.0	1265.1	1448.3	1574.9	1613.1	1679.3	NA
GNP PER CAPITA, US$	221.5	234.3	258.6	271.5	273.4	275.3	NA
EXPORTS, FOB, MILL US$	111.5	109.9	102.9	120.9	144.1	131.5	NA
CURRENT ACCT. BAL., MILL US$	-47.9	-73.5	-86.6	-48.7	-41.6	NA	NA
TOTAL EXTERNAL DEBT, MILL US$	163.8	177.3	198.1	228.2	255.0	324.5	NA
CONSUMER INFLATION, 1980=100	100.0	106.5	119.8	127.7	134.6	137.0	NA
US$/FRANC, PERIOD AVERAGE	0.01	0.01	0.01	0.01	0.01	0.01	0.01
POPULATION, MILL.	5.2	5.4	5.6	5.8	5.9	6.1	NA

MONETARY SURVEY

	80	81	82	83	84	85	86
MONEY SUPPLY, M2, MILL. FRANCS	15226.0	15982.0	16172.0	18076.0	19892.0	23430.0	NA
CONSUMER INFLATION, 1980=100	100.0	106.5	119.8	127.7	134.6	137.0	NA
WHOLESALE PRICE INDEX,1980=100	NA	NA	NA	NA	NA	NA	NA
DISCOUNT RATE	9.0	9.0	9.0	9.0	9.0	9.0	NA
COMMERCIAL PRIME RATE	NA	NA	NA	NA	NA	NA	NA
GOVT. BOND YIELD, MEDIUM TERM	8.5	8.5	8.5	8.5	8.5	8.5	NA
DEGREE OF MONETIZATION	NA	NA	NA	NA	NA	NA	NA

228

RWANDA

CONSOLIDATED BALANCE SHEET OF
COMMERCIAL BANKS
MILLION FRANCS

ASSETS	80	81	82	83	84	85	86
RESERVES	999.0	433.0	585.0	873.0	966.0	1391.0	NA
FOREIGN ASSETS	1976.0	2424.0	2600.0	2060.0	3294.0	2702.0	NA
CLAIMS ON GOVT.	426.0	648.0	1220.0	1982.0	2757.0	3067.0	NA
CLAIMS ON PRIVATE SECTOR	5689.0	7090.0	7742.0	8084.0	10021.0	13140.0	NA
LIABILITIES							
DEMAND DEPOSITS	5019.0	5191.0	4777.0	5056.0	5742.0	6306.0	NA
TIME AND SAVINGS DEPOSITS	3065.0	3237.0	4090.0	5306.0	6154.0	8184.0	NA
FOREIGN LIABILITIES	781.0	1265.0	2330.0	1764.0	1647.0	2317.0	NA
GOVT. DEPOSITS	166.0	714.0	836.0	916.0	1824.0	1711.0	NA
CREDIT FROM CENTRAL BANK	572.0	512.0	742.0	1113.0	1810.0	2729.0	NA
CAPITAL ACCOUNTS	499.0	788.0	1015.0	1330.0	2096.0	2458.0	NA
VALUATION ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
OTHER ITEMS, NET	-818.0	-843.0	-1243.0	-1635.0	-1533.0	-2728.0	NA

BALANCE SHEET OF CENTRAL BANK

ASSETS	80	81	82	83	84	85	86
FOREIGN ASSETS	17321.0	16071.0	11921.0	10927.0	11151.0	10595.0	NA
CLAIMS ON GOVT.	1232.0	1219.0	2483.0	3887.0	3936.0	3519.0	NA
CLAIMS ON OFFICIAL ENTITIES	25.0	7.0	14.0	2.0	2.0	2.0	NA
CLAIMS ON COMM. BANKS	504.0	417.0	730.0	1027.0	1643.0	2830.0	NA
CLAIMS ON SPECIAL BANKS	36.0	93.0	356.0	601.0	532.0	598.0	NA
LIABILITIES							
RESERVE MONEY	7978.0	6964.0	7237.0	8065.0	8559.0	9583.0	NA
OF WHICH							
CURRENCY OUTSIDE BANKS	5689.0	6085.0	6260.0	6662.0	7030.0	7161.0	NA
QUASI-MONEY DEPOSITS	135.0	972.0	623.0	453.0	395.0	547.0	NA
FOREIGN LIABILITIES	3469.0	3203.0	2360.0	3077.0	3005.0	1807.0	NA
CAPITAL ACCOUNTS	NA	NA	NA	NA	NA	NA	NA
RESCHEDULING ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
VALUATION ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
OTHER ITEMS, NET	3488.0	3230.0	2019.0	2170.0	2595.0	2729.0	NA

RWANDA

GOVERNMENT FINANCE
MILLION FRANCS

	80	81	82	83	84	85	86
DEFICIT(-)/SURPLUS(+)	-1875.0	NA	NA	NA	NA	NA	NA
REVENUE	13805.0	NA	NA	NA	NA	NA	NA
EXPENDITURE	15458.0	NA	NA	NA	NA	NA	NA
FINANCING							
DOMESTIC	1139.0	NA	NA	NA	NA	NA	NA
FOREIGN	2858.0	NA	NA	NA	NA	NA	NA

INTERNATIONAL DEBT
MILL. US$

	80	81	82	83	84	85	86
TOTAL EXTERNAL DEBT, (EDT)							
LONG-TERM DEBT	163.8	177.3	198.1	228.2	255.0	324.5	NA
PUBLIC AND PUBLICALLY GUARANTEED	163.8	177.3	198.1	228.2	255.0	324.5	NA
PRIVATE NONGUARANTEED	0.0	0.0	0.0	0.0	0.0	0.0	NA
USE OF IMF CREDIT	0.0	0.0	0.0	0.0	0.0	0.0	NA
SHORT-TERM	26.0	20.0	21.0	16.0	37.0	27.0	NA
TOTAL LONG-TERM DEBT							
DEBT OUTSTANDING AND DISBURSED	163.8	177.3	198.1	228.2	255.0	324.5	NA
DISBURSEMENTS	33.5	27.5	32.5	41.7	52.1	64.3	NA
PRINCIPAL REPAYMENTS	2.5	2.3	4.7	5.3	6.5	11.0	NA
NET FLOWS	31.0	25.2	27.8	36.4	45.6	53.3	NA
INTEREST PAYMENTS	1.8	2.0	2.3	2.6	3.6	4.4	NA
NET TRANSFERS	29.2	23.2	25.5	33.8	42.0	48.9	NA
TOTAL DEBT SERVICE	4.3	4.3	7.0	7.9	10.1	15.4	NA
PRINCIPAL RATIOS							
TOTAL EXTERNAL DEBT							
EDT/XGS)	104.0	112.2	138.8	152.1	159.8	NA	NA
EDT/GNP)	16.5	15.6	15.1	15.5	18.1	20.9	NA
INTERNATIONAL RESERVES	186.6	173.1	128.4	110.9	106.9	113.3	

230

G. SENEGAL

1. MACROECONOMIC SURVEY

a. Introduction and Discussion of Key Problems

Senegal's economic development since Independence in 1960 has been troubled by a particularly low growth rate in comparison to other African countries. With the exception of a short boom period in the mid-1970s, caused by strong export prices for groundnuts and phosphate, the average GDP growth rate over the last 20 years has been on the order of 2.3% p.a. An important factor in Senegal's poor performance has been the frequent occurrence of drought which has limited the contribution of the agricultural sector and constrained exports and industries based on agriculture. The government's approach to development has been an interventionist one, characterized by nationalization, regulation and the creation of parastatal enterprises in most areas of economic activity. This development has been financed through an expansionist monetary and credit policy, with increasing recourse in the 1970s to foreign debt and greater commercial bank borrowing. An inevitable result of these policies has been the progressive weakening of the private sector, through financial disincentives and bureaucratic encumbrances.

By the late 1970s, mounting fiscal deficits and a widening balance of payments gap forced government to begin a process of serious adjustment. In late 1979, the government endorsed a medium-term program (1980-84) for economic and financial adjustment, which was supported by the IMF and the World Bank. However, this program was derailed by a further downturn in macroeconomic performance and the stabilization dialogue was not renewed until late 1984. As of 1980, the government deficit represented 11.5% of GDP and the current account deficit of the balance of payments, 14.5% of GDP. Government's share of total domestic credit stood at 42%, including debt of the parastatal sector, and the medium- and long-term portions of external public debt were equivalent to 32.7% of GDP. It is estimated that 1980 urban and rural incomes were lower in real terms than 1960 levels.

Stabilization efforts got back on track in 1984 with a three-year action program (1985-87), the main objectives of which were to reduce the BOP gap and the fiscal deficit, to improve public resource management, and to increase incentives for agricultural and industrial growth. The program received the financial support of a World Bank Structural Adjustment Credit and an IMF Stand-By Facility. Progress to date has been judged uneven but basically satisfactory in stemming further deterioration of the economy.

In the area of public finance, the government deficit was dramatically reduced from a level of 8.2% of GDP in 1982/83 to 3.5% in 1984/85, and an estimated 2.3% in 1985/86. This was

achieved largely through expenditure reductions, with extensive cuts in development and current operating budgets and containment of wage bill increases. Revenue performance was not as good as expected, due to declines in income resulting from drought in 1984, lower imports and higher levels of illicit trade (resulting from increased customs duties), and continued problems in tax administration and collection. The balance of payments position improved substantially over the situation in the early 80s, however, it has remained sluggish in 1985 and 1986 at 9% to 10% of GDP, respectively, due mainly to the inability to cut imports any further due to uneven growth in export volumes and a reversal of the terms of trade in 1986, which had shown strong improvement since 1980. Inflation has also been brought down from a level of 11.4% (as measured by the GDP deflator) in 1980 to 9.3% in 1985 (preliminary estimates of 7.5% in 1986) as a result of tighter monetary control, reductions in import prices of rice and petroleum, and recent improvement in the value of the FCFA vis-a-vis the US dollar. The major sources of inflation in 1985-86 have been domestic -- (i) increases in the cost of food and housing, (ii) progressive deregulation of price controls; and (iii) reductions in subsidies.

As a result of these efforts, the economy is beginning to show signs of a gradual turnaround; after a dismal year in 1984, when severe drought caused a drop in GDP by about 4.6%, GDP grew at 3.8% in 1985 and estimates for 1986 were expected to exceed 1985 levels. However, these improvements were won at great cost to the level of government services and maintenance, general wage incomes, development expenditures and the general standard of living, and greater austerity measures are required in the medium term to consolidate recent gains and to carry through on extensive restructuring of the government sector and the private economy.

b. Current Situation and Medium-Term Development Prospects

In 1985, Senegal had a population of about 6.5 million, growing at an estimated rate of 2.9% p.a. The GNP per capita was about US$370. Urban and rural disparities remain enormous, causing a continual rural exodus to Dakar (with over a 1.5 million inhabitants) and several of the larger regional capitals, where unemployment and marginal living conditions strain the urban economy and contribute to instability. The primary sector contributes about 19% of GDP (of which agriculture, 45%); the secondary sector, 28% (of which mining, 6%, oil mills, 7%, construction, 24%, energy, 6%, and other industry, 57%); transport and commerce, 30%; and government and other services, 23%. Exports earnings in 1985 were derived in large part from the primary sector (mainly groundnuts, fish and cotton) which contributed 37.5%, from phosphates, 12%, and from petroleum products, 19.5%.

Senegal's medium-term development prospects will depend on achieving greater food self-sufficiency and diversifying and increasing exports, developing the industrial and mining

232

potential, improving management and efficiency of public resources, and reducing population growth. The macro economic policy framework for the medium-term adjustments includes significant reductions in levels of private and public consumption, increasing domestic savings, and promoting higher levels of private investment. This ambitious agenda faces immense challenges and constraints. In agriculture, the challenges include improving technical packages, encouraging the private sector to take over the role of the defunct parastatal, ONCAD, in the areas of input services and marketing, and maintaining stable producer prices. Sources of potential constraints are the international price of groundnuts, the precariousness of rainfall conditions and the effect of increasing desertification in the northern and eastern regions of the country. Promotion of the industrial sector will require a revitalization of the private sector through major changes in investment incentives, promotion of international competitiveness of domestic industry and progressive privatization of the parastatal sector. Constraints include the heavy indebtedness and poor performance of the parastatal industries, which make them unattractive to private investors, high labor costs resulting from protectionist labor legislation, the costly short-term impact of reductions in domestic protection, and the need for massive new investment at a time when the banking sector is struggling with high levels of public debt and increasing levels of bad debts. Finally, restructuring of government's revenue base and improved focus and management of expenditures faces constraints of institutional capacity for carrying out needed reforms and the inevitable political pressures arising from necessary austerity program in the medium term.

The implications of these reform policies for the financial sector are profound. On the one hand, tighter monetary and credit policies -- a sharp reversal of expansionist policies in the 1970s and early 1980s, imply strict limitations on the growth of domestic credit. On the other hand, the demands on the banking system from the public and the private sector are greater than ever. As described below, these demands come at a time when the banking sector is least capable of responding to new investment demands. In addition, the present regulatory framework, particularly as regards the interest rate restrictions, does not provide sufficient incentives to mobilize new deposits or to extend new loans to relatively high risk production activities requiring long-term financing commitments.

2. FINANCIAL SECTOR

a. Structure and Major Institutions

As a member of the West African Monetary Union (UMOA), Senegal shares a common currency, the CFA franc (pegged to the French Franc at the rate of FF 0.2 to CFA 1.0), and a common central bank, the BCEAO, with the other six member countries(see also discussion under Niger and Mali chapters). The formal financial sector consists of 14 commercial banks (including one

233

which was placed under the supervision of the Ministry of Finance in 1985 as a result of insolvency), five finance companies, and a number of non bank financial institutions, including about 15 insurance companies, a private sector pension fund (IPRES), and the national postal savings institution. A list of the financial institutions is provided in the Annex, Table 1. As of September, 1986, total assets of the banking system were approximately FCFA 620 billion (US$ 1.92 billion). The most comprehensive treatment of the financial sector is provided in the report by Ms. J. Damon (USAID), The Operation of the West African Monetary Union and the Financial Sector in Senegal, dated May 1, 1986.

Several features of the Senegalese banking system should be noted. First, the number of banks has grown fairly steadily since 1960; four new banks have been established since 1982. There were a total of 59 bank branches in 1986, 34 of which were in the capital. Nine banks have only one branch, but the other five banks together cover 13 locations, which is relatively good coverage in comparison to that of many other African countries. Second, government has either a direct and/or indirect ownership in nine banks (indirect ownership meaning a participation via another financial institution with majority government ownership). Five of the six largest banks (i.e. in terms of market share of total banking assets) have varying degrees of government ownership. Third, a number of the public finance institutions were established to serve specialized credit needs: inter alia the Banque de l'Habitat du Senegal (BHS), which is specialized in providing short, medium- and long-term credit to public and private developers of low and medium-cost housing; the Societe Financiere Senegalaise pour le Developpement de l'Industrie et du Tourisme (SOFIDEDIT), providing medium- and long-term credit for industry and the tourism sector; and the Caisse Nationale de Credit Agricole du Senegal (CNCAS), recently established in 1985 to cater to the credit needs of agriculture and rural development. Fourth, there are only two wholly foreign-owned banks, Citibank and BCCI; their shares of total lending are small, but they play a major role in trade finance.

Selected features of the six largest commercial banks are presented in Table 1. The largest banks are, perhaps not surprisingly, among the oldest banks in the country. Together, this group of banks accounted for 89% of total assets in the banking system and 91% of total loans outstanding in 1985. Government is the majority shareholder in the two largest banks, the Banque Nationale de Developpement du Senegal (BNDS) and the Union Senegalese de Banque (USB), and has a substantial position in the Banque Internationale pour le Commerce et l'Industrie du Senegal (BICIS) and the Banque Internationale pour l'Afrique (BIAO). These banks have increasing recourse in recent years to BCEAO refinancing facilities and have, as a group, been responsible for exceeding the refinancing ceilings set by the central bank (in 1985, total banking system refinancing limits were set at about 35%). Through this group of banks,

TABLE I: SENEGAL SELECTED FEATURES OF THE BANKING SYSTEM (9/30/85)

Bank	Year Estab.	Govt Ownshp. %	1 Share of Tot.Assets %	Share of Tot. Lns. %	BCEAO Refinance of Ln. Ptfolio %	Number of Branches
BNDS	1964	75	29.6	23.4	76.8	8
USB	1961	65.24	15.7	19.2	52.8	11
SGBS	1969	0	14.7	17.2	25.7	7
BICIS	1962	42	12.0	13.2	26.6	13
BIAO	1980	35	11.7	13.8	25.0	11
BSK	1974	5	5.3	4.5	51.7	1
Sub-total			89.0	91.3	99.1	51
Other banks			11.0	8.7	0.9	8
TOTAL			100.0	100.0	41.9	59

Source: World Bank and BCEAO Annual Reports

1 Direct or indirect ownership.

particularly the BNDS and USB, the government has exercised substantial control over the banking system. For example, the BNDS has been responsible for organizing the financing of seasonal crop credit for the government through a consortium of banks. These six banks now hold the outstanding debt of the defunct ONCAD, the parastatal responsible for input supply and output marketing of groundnuts in the major producing areas(see further details below). In sum, while the banking sector in Senegal is relatively developed and extensive by African standards, it is heavily dominated by government interests, both in the general and specialized lending areas; this is reflective of the highly directed approach of the government to economic development.

b. The Informal Sector

We have no detailed information on savings and credit in the informal sector.

c. UMOA Inter-Bank Money Market

An over night inter bank money market was created in July 1975 to induce banks to maintain excess liquidity in the Union. As of August 1978, the money market was expanded to include one-month and three-month deposits and advances. Inter bank rates are set by the BCEAO and have been adjusted in tandem with rediscount rates. The BCEAO also controls bank participation in the market. Only those banks which have not used central bank rediscounting facilities may invest in the market (this is to avoid banks investing rediscounted funds in the higher rate inter

235

bank market). BCEAO also exercises control over the rationing of advances and sets eligibility criteria for collateral which must be pledged against these advances. Interest rates on deposits and advances are provided in the Annex, Table 2.

The Senegalese banks are very active in the inter bank market; as of 1984, transactions in Dakar accounted for about two-thirds of total transactions in the Union. Demand for advances has consistently outstripped supply of inter bank deposits, and the Senegalese banks' are structurally in deficit in the market.

d. Financial Sector Regulation

The financial sector in Senegal is regulated within the overall monetary and credit policy framework established by the UMOA, and implemented by the BCEAO through a variety of quantitative and qualitative controls. The major instruments of control include: (i) ceilings on total credit expansion, (ii) statutory limits on government borrowing, (iii) limits on the amount of refinancing of private sector credit, (iv) reserve requirements, (v) controls on the eligibility of commercial paper for rediscounting, (vi) interest rates on deposits and lending, (vii) management of the inter-bank money market, (viii) foreign exchange restrictions, and (ix) selective credit controls. The National Credit Committee is responsible for making recommendations on the level of the country credit ceilings and for determining the internal allocation of credit among institutions and sectors.

i. BCEAO Monetary and Credit Policy, 1977-1985

A review of BCEAO monetary and credit policy over the last decade is useful background for understanding the application and effectiveness of specific regulatory controls of the banking system during this period. Throughout the 1970s and early 80s, the BCEAO pursued an expansionist monetary and credit approach, with an overriding concern for the liquidity needs of the economy and a secondary concern for the inflationary impact of monetary expansion and the net external position of the country. Between 1977 and 1982, domestic credit grew at annual rates averaging about 20%. While most of the increase in domestic credit during this period went to finance the private sector, government borrowing increased sharply and substantial amounts of credit were also channelled into the parastatal sector. In 1980, credit to households and private enterprise accounted for about 54% of domestic credit; government borrowing represented only 6%, but parastatal credit amounted to about 36% of the total (the largest share of which was credit to ONCAD). Beginning in 1983, the BCEAO began tightening up on the money supply and domestic credit, and in coordination with the IMF stabilization measures succeeded in (i) reducing money in circulation to 7.4% of GDP in 1985 (M1 as a percentage of GDP fell from 24.4% in 1981 to 16.8%; similarly, M2 was reduced from 32.4% of GDP in 1981 to 26% in 1985) and (ii) slowing the growth in domestic credit to about

736

2.7% p.a. in 1985. Reductions in domestic credit were largely at the expense of new private sector credit as government cut back on foreign borrowings and began to draw heavily on the banking system. By the end of 1984, the government's share of total domestic credit stood at 24.5%; parastatals represented another 25.5%, and credit to the private sector was reduced to 45% (see Annex, Table 3).

ii. Credit Ceilings

Credit control is exercised mainly through the establishment of annual ceilings for commercial bank and government refinancing with the central bank. Annual levels are set by BCEAO in consultation with the National Credit Committee of Senegal and in consideration of numerous factors including GDP performance and projections, objectives for the evolution of net foreign assets, the BOP, and financing of the public deficit. In principle, commercial bank refinancing has been limited to 35% of total assets for the banking system (in 1974, the BCEAO abandoned the practice of establishing refinancing limits for individual banks; the National Credit Committee in Senegal, however, has apparently continued this practice); the statutory limit on government refinancing is set at 20% of the government's recorded receipts in the previous fiscal year. In contrast to the IMF limits on total domestic credit expansion and the government's share of domestic credit, BCEAO refinancing ceilings constitute only a partial control of credit expansion, because (i) it has no impact on credit financed by deposit resources or foreign borrowings, (ii) it does not limit indirect Government borrowing through the parastatal sector, and (iii) certain types of credit are exempt from the ceilings, including, in particular, crop credit.

Until recently, the BCEAO has made little or no effort to enforce the credit ceilings on the banking sector. Between 1976 and 1984, commercial bank refinancing exceeded specified ceilings every year, by substantial margins ranging from 10% to 70% up until 1982, when the excesses dropped to between 3% and 5%. This does not include annual refinancing of crop credit which represented 5% to 10% of total domestic credit during this period. With the exception of 1977, BCEAO advances to government have remained within the statutory limits. However, over the same period, the government resorted to other measures to finance the deficit, including (i) foreign borrowing, (ii) obliging parastatals to place their deposits in commercial banks in order to expand government borrowing capacity, (iii) increasing parastatal borrowings which are defined as private credit, and (iv) accumulation of arrears in payments on government contracts and on parastatal debt.

In short, both the lack of BCEAO enforcement and ineffective design of BCEAO credit controls have been responsible for the high growth in domestic credit up until 1983-84, when stabilization measures were adopted. However, even after total credit growth had been strictly curbed, the government was still able to take advantage of the loopholes in the regulations to

237

expand its direct and indirect borrowings from the commercial banks and to use its prerogative to expand foreign borrowings for government and debt guaranteed by government. As such, the government in recent years has been technically in compliance with IMF ceilings for domestic credit growth and net claims of the banking sector on government, and technically in compliance with BCEAO ceilings on government refinancing while, in fact, increasing effective "crowding out" of the private sector and contributing to inflationary pressures through foreign borrowing and other methods which indirectly create new demands for credit. These problems need to be addressed through closer IMF-BCEAO coordination, including eliminating exceptions to the BCEAO refinancing limits and redefining government borrowing limits to take account of at least part of parastatal debt, government's standing on credit repayments and other accumulated debts, and foreign borrowings.

iii. Refinancing of Commercial Bank Credit

The commercial banks have recourse to three types of refinancing instruments with the BCEAO. The main option is the rediscount facility under which banks can obtain 6-month refinancing for short-term loans, 9-month refinancing for government procurement credits and seasonal crop loans, and up to 12-month refinancing for medium-term credit. A second form of refinancing is that available through short-term advances which BCEAO grants against short-term securities. Borrowing on the inter bank money market, managed by the BCEAO, is the third option, although this is limited to those banks that have not requested BCEAO advances or used the rediscount facility, in order to avoid the possibility of banks borrowing using rediscounted funds to invest in the higher rate inter bank market. Since demand for inter bank funds has consistently exceeded supply, BCEAO a has direct role in rationing the use of these funds. The BCEAO has the right to call in its advances at any time and to require banks to redeem their securities. Interest rates applicable to these three refinancing options are given in the Annex, Table 2.

The BCEAO has strict definitions on the types and quality of securities that can be accepted as collateral against each different type of advance. Only category one securities are accepted for inter bank market borrowings; category two securities require review of recent financial statements of the borrower plus additional guarantees; category three securities are not eligible as collateral. The National Credit Committee is responsible for verifying the quality of securities presented to BCEAO. The BCEAO also imposes limits on the amount of medium-and long-term refinancing available on different types of bank credits. The percentage of allowable refinancing ranges from 30% on construction of non priority developments to 65% on industrial projects, 75% on agricultural production, and 90% on credits to small- and medium-scale national enterprises and primary home construction for residents.

136

As mentioned above, the commercial bank refinancing ceilings were not enforced until 1983-84. Total levels of bank refinancing were on the order of 50% of total credit to the private sector outstanding (including credit to parastatals) in 1981; this was reduced to 45% in 1985, equivalent to 27% of total bank assets, and therefore within the 35% limit. This facility has been used to a varying extent by the banks; as of 1985, the six largest banks accounted about 99% of all credit refinanced. The increased use of BCEAO refinancing in recent years has, due to inadequate quality control, led to a deterioration in the quality of the securities held in the BCEAO portfolio. This weakness was exposed in 1984, when the Council of Ministers of the UMOA requested an inquiry into the portfolio of rediscounted credit of its member countries and as a result the BCEAO branch in Senegal was required to reject about FCFA 50 billion worth of unqualified securities for immediate redemption by the commercial banks (Darmon, p. 93). Thus, the present task of reducing overall credit growth needs also to be coupled with a detailed portfolio review of the assets of the BCEAO and an effort to upgrade the portfolios of individual banks in the system.

iv. Reserve Requirement

While the BCEAO has the ability to impose reserve requirements on the commercial banks, it has never imposed such requirements and relied fairly exclusively on the refinancing limitations to exercise a control over credit expansion. In Senegal, the National Credit Committee sets monthly credit limits for individual banks, thus increasingly forcing banks with excess liquidity to place them with the BCEAO, as one of several options. Senegalese banking law also requires banks to maintain their own reserve to cover bad and doubtful debts. The mandatory level was set at 6% of outstanding loans; reserves are not calculated on government debt or government-guaranteed debt, as these are considered fully secured. Few banks were complying with this regulation prior to 1982; however, the general deterioration of loan portfolios has forced banks to increase their reserves to at least the required level. For most of the large banks, the 6% level far underestimates the non performing loans (see below under Performance of the Banking Sector).

v. Interest Rates Regulation

The structure and level of deposit and lending rates are set by the UMOA and apply across all member countries. Lending rates are controlled by establishing rates on credit rediscounted by the BCEAO and by fixing the margins that banks can apply on rediscounted funds. There are two rates on rediscounted credit, a preferential interest rate (taux d'escompte preferentiel, TEP) for loans to priority lending activities as defined by the UMOA and another rate, 2.5 points higher for all other loans (taux d'escompte normal, TEN). The rate structure varies according to loan use, but takes no account of the maturity of loans. Bank margins on rediscounted credit range from 1% to 3% on priority loans and 0 to 5% on all others. Senegal imposes a "service" tax

239

on interest rates (tax on the provision of services, TPS), which is currently 17%, and payable by the borrower. Table 2 summarizes the structure of lending rates and the evolution of these basic rates over the last ten years. Using the GDP deflator as a proxy for inflation, basic bank lending rates (before commissions and tax) have been positive in real terms for most loans over the period 1980 to the present. However, lending rates on preferential loans accorded the minimum rates were marginally negative over most of this period. Minimum lending rates for non bank financial institutions have been 22.5% since September 1986.

Minimum required deposit rates are outlined in Table 3. Sight deposits under a minimum of FCFA 200,000 earn no interest; sight deposits over this amount were remunerated at between 3.5% and 4% from April 1983 to January 1985, at which time, the BCEAO agreed to a two-year moratorium on payment of interest on sight deposits to assist in improving the financial position of the banks. Interest rates on term deposits as of September 1986 varied from 4.25% on a minimum FCFA 200,000 deposit under 6 months to 8% for the largest fixed-term deposits of over 1 year. Interest rates on all but the largest of term deposits held for 1 year or more have been negative in real terms. However, the relative attractiveness of term deposits over sight deposits (and other short-term placements) has resulted in an extremely high rate of growth in time deposits over the last decade; between 1977 and 1981, time deposits grew at an average annual rate of 48% in comparison to sight deposits, which grew at only 9% p.a. over this period. These rates of growth have slowed considerably in recent years, reflecting recession and efforts to curb growth in the money supply; term deposits grew at an average rate of about 19% p.a. and sight deposits at 4.8% p.a. in nominal terms over the period 1981-85. The interest rate structure for bank notes is identical to that for term deposits.

vi. Foreign Exchange Regulation

A complex set of regulations governs foreign exchange transactions within and outside of the UMOA. Concerning trade transactions, all imports from outside the franc zone require prior authorization of the Ministries of Commerce and Finance; imports from franc zone countries of specific goods which are also produced in Senegal also require prior authorization from the Ministry of Commerce. All sizable foreign exchange transactions are required to be managed by an authorized bank in Senegal, and transfers of funds within the franc zone and to or from countries outside the zone are required to pay a duty varying from 0.10% to 2.5% per million. Transfers of personal income of non residents (profits, dividends, and royalties) are permitted; however, transfers of capital to non franc zone countries require prior approval of the Ministries of Commerce and Finance. Foreign borrowing is tightly controlled and require prior authorization with the important exceptions of government-guaranteed loans and borrowings under an amount of FCFA 40 million. Foreign direct investment requires prior

authorization, and Senegalese law requires new ventures to have a minimum of 51% Senegalese ownership. The purchase or sale of foreign securities is strictly limited. Restrictions on foreign borrowing and direct foreign investment constitute major obstacles to private sector investment, particularly in recent years, when domestic bank credit to the sector is severely limited and the few likely Senegalese investors have suffered the impact of recent recession. In contrast, these regulations have enabled the government and the parastatal sector benefitting from government guarantees to continue foreign borrowing to finance their deficits.

TABLE 4: SENEGAL- SECTORAL CREDIT POLICY: TARGETS AND ACTUAL

1982-85

s Actual) 12/85(%)	Targets 1982-84(%)	Actual 1982(%)	Actual 1983(%)	Actual 1984(%)	Target 1985(%
PRIORITY LENDING					
Short-term loans 38.7	36.0	39.3	42.7	37.9	40.0
Agriculture, Livestock 4.1	4.0	4.0	4.3	4.4	3.0
Fisheries 3.1	1.5	1.4	1.5	1.7	2.0
Ind., Artisans, Tourism 22.9	20.0	22.8	26.6	23.0	22.0
Cvl Eng, Constr. 6.3	8.5	9.0	8.0	6.7	7.0
Transport 0.7	2.0	2.2	2.2	2.1	4.0
Soc. Housing Dvlpmt. 0.7	--	--	--	--	4.0
Med & Long-term Loans 24.9	31.0	24.0	22.1	25.8	31.0
Primary Sectors & Indus., Artisans, Tourism 11.7	16.0	11.6	10.2	12.5	16.0
For. Asset Purch. by Natls 0.3	1.5	1.1	0.7	0.2	1.5
Housng for Nationals 8.9	11.0	9.3	9.6	9.5	11.0
Equpmt, Prod.Investment 4.0	2.5	2.0	1.6	3.6	2.5
Total Priority Lending 63.6	67.0	63.3	64.8	63.7	71.0
NON-PRIORITY LENDING					

Other Loans 9.7	6.0	11.2	11.0	9.2	2.0
Total Non-Priority Lending 36.4	33.0	36.7	35.2	36.6	29.0
Lending Subject to Policy 292.9 (in CFA billion)	100.0%	214.9	250.1	264.2	100.0

Source: World Bank and BCEAO Annual Reports

vii. Selective Credit Controls

The National Credit Committee exercises control over the allocation of credit through the establishment of sector lending targets (implemented in 1977), to which sub targets for medium and long-term lending were added in 1982. These targets are enforced indirectly through (i) the requirement that banks obtain prior authorization from the Credit Committee for all loans which would bring a borrower's total indebtedness to over FCAF 70 million and (ii) government pressure brought to bear directly on the banks. Due to the added bureaucracy and delays in seeking prior authorization, an increasing number of loans are granted without authorization. Informed sources indicated that the value of unapproved loans is on the order of twice that of authorized loans; however, since many of the unauthorized loans are of a highly short-term nature, they go undetected. Table 4 compares commercial banks' actual lending against stated lending objectives during the period 1982-85. The statistics on banks' lending activities reveal that short-term lending has corresponded fairly closely to established lending targets; in fact, up until 1985, when targets were adjusted, mainly upward, short-term lending to priority sectors has exceeded government targets. Bank medium- and long-term lending; however, has fallen consistently short of the targets; the shortfalls have been in the more critical areas of loans to the primary sector, industry, artisanal production and tourism.

Overall bank performance on sectoral credit policy suggests several conclusions. First, while data on individual bank compliance with lending targets are not available, it is generally accepted that the commercial banks with high levels of government ownership have borne more than their share of targeted lending. This is certainly a contributing factor to the declining financial performance of these banks. Secondly, the fact that short-term priority lending targets have been consistently surpassed suggests that overall bank lending patterns were not significantly different from the official targets until 1985, when bank lending fell short of the new targets for low income construction projects, a priority lending category that was added in 1985. Thirdly, as regards medium- and long-term lending targets, it is evident that banks have been unwilling to assume the greater risks associated with term loans without greater financial incentives than are provided in the present structure of interest rates.

viii. Performance of the Banking Sector

The overall growth and performance of the banking sector in recent years has been negatively affected by the general economic recession, an increasing burden of government and parastatal debt, and diminishing margins squeezed by higher costs and a deteriorating loan portfolio. Reform measures, which have tightened growth in domestic credit and reduced foreign borrowing

248

by the banks, have exacerbated these trends and increased the urgency for further measures to address structural problems in the financial sector.

Annual growth in domestic credit between 1980 and 1985 was reduced from a level of 22% in 1980 to 13% in 1985, with an average annual increase of about 10% from 1982-85, resulting in negligible real growth during this period. The heaviest burden of adjustment has fallen on credit to the private sector. The portion of total credit to the private sector (including parastatal enterprises) actually declined by 3.5% p.a.in real terms between 1981 and 1985. By 1985, the government and parastatal enterprises accounted for over half of total credit.

During recent years, the composition and cost of bank resources has also changed significantly. The overall portion of bank deposits in total sources for private sector lending decreased from an average of 58.5% over the period 1975-79 to about 50.5% between 1980 and 1984. In addition, the coverage of credit by sight deposits fell from an average level of 41% (sight deposits to bank private sector lending) over 1975-79 to 29% in 1980-85, while coverage by term deposits (paying 3% to 5% higher deposit rates) increased from an average coverage of 15% during the earlier period to 21% in recent years. A shrinking deposit base and declining performance in loan repayment and turnover of bank funds has resulted in an increasing use of the BCEAO rediscounting facility, inter bank and correspondent bank borrowings, and thus, higher average borrowing costs.

Financial profits and viability of the banking system have been further eroded by a decline in the average returns on the uses of funds. Three major factors are responsible, including: (i) the low level of regulated interest rates and commissions, (ii) pressure on the banks to increase lending to priority sectors, and (iii) large increases in non-performing loans. The BCEAO-regulated interest rate structure has, in fact, been progressively lowered, by a total of 4 points, since 1982 (see Annex, Table 2). As mentioned above, the large government-dominated banks have come under significant pressure to expand their share of priority lending. This has both increased the risk exposure and lowered the interest revenue of these banks.

The amount of non performing loans in the banking system has increased substantially since the mid-1970s, and there is a consensus among informed sources that the overall level of bad and doubtful debts far exceeds that which is reported. The actual amount of reported bad and doubtful debts for the banking system as a whole was FCFA 6 billion in 1976; this rose to FCFA 26 billion by the end of 1985. Approximately 85% of these bad debts are held by the commercial banks with large government ownership. These amounts grossly underestimate the impact of the non performing loans because bad debt provisions are not calculated on government debt or loans guaranteed by government.

244

A critical example of the non performance of parastatal debt is the case of ONCAD, the major parastatal involved in the groundnut sector which was dissolved at the end of 1980 (Darmon, pp. 77-84). At that time, ONCAD debt to the commercial banks stood at FCFA 94 billion (US$416 million), equivalent to about 34% of total banking sector loans to the private sector in 1980. Out of the total ONCAD debt, FCFA 75 billion represented outstanding and unpaid loans for crop credit, inputs and food relief. Most of the ONCAD debt was held by the BNDS (58%) and USB (14%); however, the four other largest banks (BIAO, BICIS, BSK, AND SGBS) each held 7% of the debt as they were part of the consortium organized by the BNDS to finance the parastatal seasonal credit program. Under pressure by government, the debt was subsequently redistributed to avoid an impending financial crisis of the BNDS. In 1982, the UMOA Council of Ministers accepted to refinance through the BCEAO the principal portion of the ex-ONCAD debt, FCFA 64.3 billion, at a special rate of 5.5% (the preferential rediscount rate prevailing during 1975-79, when the debt was incurred); the government agreed to reimburse the banks for the interest portion of the debt and interest accruing on the principal to be paid down over a 15-year period by the banks. In addition, it was accepted that the refinanced debt would be placed in a special account not subject to the BCEAO and IMF credit ceilings. This decision was later reversed in June 1985. As of that date, the government had already fallen into arrears of FCFA 10 billion of its obligations to the banks holding ex-ONCAD debt, although adjustment of these arrears has now become a performance criterion under IMF agreements with the government.

In summary, a combination of the above factors has contributed to the deteriorating financial performance and increased instability of a number of commercial banks. Performance on selected indicators reveals some worrisome figures (Annex, Table 4). Six banks reported net losses in 1984, and three in 1985. Only half of the 12 banks in 1985 met the short-term liquidity requirement (short-term assets to short-term liabilities of 0.75). Eight out of the 12 banks (excluding newly created banks, CNCAS and SONABANQUE) in 1985 had a ratio of capital and reserves to total assets of less than 0.05, considered acceptable.

ix. Distribution of Bank Credit

Table 5 provides a breakdown of banking sector credit to the private sector (including parastatal enterprises) as of December 1985. A number of points are worth noting as a complement to the analysis above regarding sectoral lending policies. One, short-term credit accounted for 60.3% of the total outstanding, medium-term credit, 22.2%, and long-term credit, 17.5%. This reflects a major jump in long-term credit since 1982, when long-term credit was only 0.4% of the total and is mainly due to increases in lending to parastatal enterprises (including refinancing of shorter-term debt). Two, over 50% of short and medium-term loans are concentrated in non-priority sectors,

245

commerce and services; this has been a consistent pattern since 1980. Three, the financing of industry and manufacturing is currently on a short or medium-term basis, largely inappropriate to the financing needs and the long-term cash-flow patterns of these businesses. Four, in 1985, the parastatal sector consumed 25% of short-term credit, 16% of medium-term credit, and 97% of long-term credit. While the total share of private sector credit going to the parastatal sector has declined slightly in recent years, parastatals have accounted for an increasing portion of term credit.

Table 5: DISTRIBUTION OF BANK CREDIT TO THE PRIVATE SECTOR

Economic Sector	Short-term % total	Medium-term % total	Long-term % total
Agr, Fish, Forestry	4.9	3.3	0.1
Extractive Industry	0.8	0.2	--
Manufacturing Indust.	23.0	29.0	0.6
Utilities	1.0	2.2	--
Construct,. Publ.wks.	7.7	7.8	--
Commerce	43.0	16.0	97.0
Transp, Storage, Commun.	3.9	6.7	--
Services	15.7	34.0	1.7
Total	100.0	100.0	100.0
Percentage of Total	60.2	22.3	17.5
% Private Enterprises	74.5	83.9	3.0
% Parastatal Enterprise	25.5	16.1	97.0

Source: BCEAO Annual Reports, Credit Reported to the Centrale des Risques

III. CONCLUSIONS AND RECOMMENDATIONS

a. Conclusions

The Senegalese Government has only recently embarked on major stabilization reforms. Progress in the initial three-year phase (1985-87) is regarded as uneven, partly due to the impact of severe drought conditions in 1984, but basically satisfactory. Macroeconomic stabilization measures have resulted in downward adjustment of the fiscal deficit, the current account of the balance of payments, and the money supply, domestic credit, and inflation. However, this improvement has been achieved at substantial costs, disruption, and uncertainty affecting the public and private sectors. It is clear that these gains can only be sustained through continued diligence and major and successful efforts to restructure the economy, including the

revitalization of the private sector, divestiture of parastatal enterprises, and improvement in public resource management.

The role of the financial sector in this adjustment process is critical, however, it is questionable whether the banking sector is capable of responding to the new challenges. A number of factors will constrain the ability of the banking system to assume a greater role in financing desired economic adjustments. First, tighter monetary and credit policy mean that the growth in domestic credit in the medium-term is likely to remain fairly flat in real terms; unless inflation can be reduced further, the purchasing power of the banks' portfolios will begin to decline. Second, the banking system is already carrying a substantial amount of government and parastatal debt, and credit to private households and enterprises has been declining steadily since 1980. Increasing private sector credit will require government to accelerate repayment of arrears on the ONCAD debt, among others, and will depend on the success of its efforts to divest portions of the parastatal sector and/or to improve the performance of these public enterprises; the prospect of these actions in the medium term are modest, at best. Third, many of the banks, particularly those with the greatest capacity to undertake diverse new lending (because of their size, experience, and branch networks), are currently crippled with increasing bad debts, a high portion of priority sector loans which generate low interest revenue, high cost structures, and large government and parastatal loans, many in arrears. Fourth, the current regulatory framework, in many of its aspects, limits the ability of the banks to regain strong financial footings and denies banks adequate incentives to take on new, higher risk and longer-term investments.

b. Recommendations

The following is a list of priority actions which we believe are necessary to revitalize the banking sector and to provide the economic and regulatory environment conducive to maximum growth with stability in the banking sector.

i) Reduce the level of government and parastatal arrears to the banking system and gradually reduce the overall level of government/parastatal borrowing;

ii) Reduce government involvement in credit decisions; study impact of selective credit controls on performance of banks with view to decreasing the specificity of lending targets to one overall priority lending percentage;

iii) Raise deposit and rediscount rates and allowable bank margins to stimulate greater savings mobilization and provide banks with the adequate spread necessary to induce new lending in priority areas; introduce rate differentials for medium- and long-term lending;

iv) Deregulate inter-bank money market rates, while limiting participation of banks which have rediscounted credit with the BCEAO in a given year;

v) Improve BCEAO/IMF coordination on definition of national credit ceilings; this may require redefinition of government borrowing capacity and elimination of special exemptions to the ceilings;

vi) Upgrade financial reporting requirements of banks and BCEAO's capacity and standards for routine monitoring of financial institutions.

vii) Reduce obstacles to foreign borrowing by the banks and the private sector; encourage greater foreign direct investment by modifying the required percentage of Senegalese ownership;

viii) Increase the minimum capitalization of the banks; open capital to new foreign and national shareholders;

ix) Increase the banks' minimum requirement for provision of bad debts;

x) Other reforms to increase financial performance of ailing banks: reduce cost structure, pursue more aggressive savings mobilization, increase efforts to collect on delinquent loans, upgrade loan appraisal process to insure borrower creditworthiness.

c. Information Gaps and Areas for Further Field Research

-Extent of informal sector saving and credit
-BCEAO financial reporting requirements and inspection capacity
-Impact of selective credit controls on bank performance
-Actual and potential role of non bank financial institutions in government financing
-Accessibility of small borrower to credit
-Informal sector saving and borrowing

218

BIBLIOGRAPHY

Arthur Young, "Summary of Financial Markets Survey", Manuscript (Washington D.C.: 1986)

Banque Centrale du Senegal, "Statistiques Economicques et Monetaires", 1987

Cabinet Aziz., "Agricultural Production Support Project", Manuscript (Washington, D.C.: 1986)

Damon, Jacki, "The Operation of the West African Monetary Union and the Financial Sector in Senegal", Manuscript, Washington, May 1986

IBRD, "Market Analysis and Project Design: an Equity Participation Fund for the Republic of Senegal", Manuscript (Washington, D.C.:1986)

IBRD, "Senegal--Recent Economic Developments", Manuscript (Washington, D.C: 1986)

IBRD, "Senegal: Policy Framework Paper, 1987-89", Manuscript (Washington, 1986)

IBRD, "Senegal: An Economy Under Adjustment - Volume 1", Manuscript (Washington:1987)

IBRD, "Senegal: An Economy Under Adjustment - Volume 2", Manuscript (Washington:1987)

IBRD, "Senegal: A Review of the Three-year Public Investment Program, 1987/88-1989", Manuscript (Washington, D.C.:1987)

IMF, "Senegal -- Recent Economic Developments", (Washington, March 13, 1986)

Nair, Govind, "The Public Financial Sector in Senegal: an Issues Paper", Manuscript (Washington, D.C.: 1985)

Universite du Senegal, "Le Credit Agricole de la Banque Nationale de Developpement du Senegal", Manuscript, 1982

AID, "Les Circuites de Financement du Senegal", Manuscript, Washington, 1982

AID, "Etude sur le Redressement du Systeme Bancaire Senegalais, Manuscript, 1986

Senegal Annex
Table 1

Senegal: List of Commercial Banks and Financial Institutions as of December 31, 1985

Commercial banks

1. Banque Nationale de Développement du Sénégal (BNDS)
2. Union Sénégalaise des Banques pour le Commerce et l'Industrie (USBCI)
3. Banque Internationale pour l'Afrique Occidentale-Sénégal (BIAOS)
4. Banque Internationale pour le Commerce et l'Industrie du Sénégal (BICIS)
5. Société Générale de Banque au Sénégal (SGBS)
6. Banque Sénégalo-Koweitienne (BSK)
7. Société Financière Sénégalaise pour le Développement de l'Industrie et du Tourisme (SOFISEDIT)
8. CITIBANK
9. Banque de l'Habitat du Sénégal (BHS)
10. Banque du Crédit et du Commerce International, Overseas, Limited (BCCI)
11. Massraf Faycal Al Islami du Sénégal (MFIS)
12. Banque Commerciale du Sénégal (BCS)
13. Caisse Nationale du Crédit Agricole (CNCA)
14. Société Nationale de Banques (SNB)

Financial institutions

1. Compagnie Ouest-Africaine de Crédit-Bail (LOCAFRIQUE)
2. Société Dakaroise d'Equipement (SDE)
3. Société Générale de Crédit Automobile (SOGECA)
4. Société Nationale de Garantie et d'Assistance au Commerce (SONAGA)
5. Caisse d'Epargne du Sénégal (CE)
6. Caisse des Chèques Postaux (CCP)

Source: List provided by the BCEAO.

Source: IBRD

250

Senegal Annex
Table 2

Senegal: Interest Rates Applied by the Central Bank, 1975-85 1/

(In percent per annum)

	July 1, 1975	April 14, 1980	April 7, 1982	April 5, 1983
Rediscount 2/ of short- and medium-term 3/ credit				
Normal discount rate	8.00	10.50	12.50	10.50
Preferential discount rate 4/	5.50	8.00	10.00	8.00
Overdraft by the Treasury	5.50	8.00	10.00	8.00
Advances against government paper	8.00	10.50	12.50	10.50
Rediscount 2/ of customs duty bills	8.00	10.50	12.50	10.50
Advances against private paper	8.00	10.50	12.50	10.50
Other advances against securities accepted as collateral	9.50	12.00	14.00	12.00

Call money market	Overnight		One-month		Three-month	
	Deposits	Advances	Deposits	Advances	Deposits	Advances
November 12, 1979	9.750	10.000	9.875	10.125	10.125	10.375
March 10, 1980	10.750	11.000	10.875	11.125	11.125	11.375
April 14, 1980	9.750	10.062	9.875	10.125	10.125	10.375
May 25, 1981	14.750	15.062	14.875	15.125	15.125	15.375
December 14, 1981	14.250	14.562	14.375	14.625	14.625	14.875
February 22, 1982	13.750	14.062	13.875	14.125	14.125	14.375
March 29, 1982	15.250	15.562	15.375	15.625	15.625	15.875
July 12, 1982	14.750	15.062	14.875	15.125	15.125	15.375
August 23, 1982	14.000	14.312	14.125	14.375	14.375	14.625
November 8, 1982	13.500	13.812	13.625	13.875	13.875	14.125
December 20, 1982	13.000	13.312	13.125	13.375	13.375	13.625
March 22, 1983	11.000	11.312	11.125	11.375	11.375	11.625
June 13, 1983	12.000	12.312	12.125	12.375	12.375	12.625
July 2, 1984	11.750	12.062	11.875	12.125	12.125	12.375
July 16, 1984	11.500	11.812	11.625	11.875	11.875	12.125
August 13, 1984	11.250	11.562	11.375	11.625	11.625	11.875
Sept. 10, 1984	11.000	11.250	11.125	11.375	11.375	11.625
October 29, 1984	10.750	11.000	10.875	11.125	11.125	11.375
January 21, 1985	10.625	10.875	10.750	11.000	11.000	11.250
April 21, 1985	10.500	10.750	10.625	10.875	10.875	11.125
May 13, 1985	10.250	10.500	10.375	10.625	10.625	10.875
November 25, 1985	9.750	10.000	9.875	10.125	10.125	10.375

Source: Data provided by the BCEAO.

1/ Dates of changes with corresponding rate structures.

2/ Includes prise en pension, a rediscount operation with promise to transfer the credit title back to the original lender.

3/ Duration of medium-term credit has been extended from 7 to 10 years. Rediscount of long-term credit having not more than 10 years to run is accepted.

4/ Applied mainly to crop credit, to credit to the Government and local authorities, to small national enterprises with total credit outstanding not exceeding CFAF 30 million, and to nationals for the construction of the borrower's first primary residence (maximum CFAF 15 million on loans under 10 years).

Source: IMF (1986)

Senegal Annex
Table 3

Senegal: Structure of Domestic Credit, 1980-84

(In billions of CFA francs; end of period)

	1980	1981	1982	1983	1984
1. Claims on Government (net)	17.9	40.7	87.5	106.9	122.3
2. Credit to parapublic sector (a + b + c)	105.2	137.8	146.2	158.1	128.2
a. Seasonal credit	23.6	33.1	33.1	21.8	14.4
(i) ONCAD 1/	14.4	--	--	--	--
Groundnuts	(10.8)	(--)	(--)	(--)	(--)
Other crops	(3.6)	(--)	(--)	(--)	(--)
(ii) SONAR	--	--	3.2	4.4	--
(iii) SONACOS	4.1	23.4	23.3	15.2	11.4
(iv) SODEFITEX	3.9	2.7	1.5	0.9	1.1
(v) SEIB	1.0	7.0	5.1	1.4	1.9
b. Other credit to ONCAD 1/	53.1	67.7	67.7	67.7	67.7
(i) Agricultural program	27.3	27.3	27.3	27.3	27.3
(ii) Other ordinary credi	25.8	40.4	40.4	40.4	40.4
c. Other credit to parapublic sector	28.5	37.0	45.1	68.6	46.1
3. Credit to households and private enterprises	158.6	178.3	195.1	198.5	226.5
4. Other	10.8	13.5	17.3	16.7	24.1
Of which: doubtful and litigious credit	(8.1)	(10.7)	(15.9)	(12.5)	(20.0)
Total domestic credit (1 + 2 + 3 + 4)	292.5	370.3	446.1	480.2	501.1

Source: Data provided by the BCEAO.

1/ ONCAD ceased operations in August 1980, and its indebtedness to the banking system is to be repaid by the Government.

Source: IMF, p.110

Senegal Annex
Table 4

FINANCIAL STATUS OF SENEGAL'S COMMERCIAL BANKS
(Period Ending September 30, 1984)

Banks(1)	Bad Loans total loans (in percent)	Capital & Reserves total loans	S/T Assets S/T Liabilities	M + L/T Assets M + L/T Liabilities	Profit (2) Margin (in percent)	Net Profits or Losses (-) (in millions of CFAF)	% of total lending not included in do credit ceilings
Bank of Credit and Commerce International	0	0.25	1.21	0.76	5.13	201.0	50.0
Banque Commerciale du Senegal	0.05	0.09	0.78	1.41	2.87	-39.9	19.5
Banque de l'Habitat du Senegal	0	0.47	4.05	0.57	8.29	317.3	25.5
Banque Internationale pour l'Afrique Occidentale	0.85	0.08	0.68	1.53	5.40	-757.5	10.2
Banque Internationale pour le Commerce et l'Industrie	3.1	0.08	0.50	2.49	4.58	161.1	46.6
Banque Nationale de Developpement du Senegal	3.8	0.09	0.43	1.98	1.35	40.1	29.4
Banque Senegalo-Koweitienne	16.6	0.14	0.80	1.79	1.25	-66.4	35.2
Citibank	0	0.14	1.27	0.28	6.71	201.1	42.2
La Masraf Faysal(4) Al Islami du Senegal	0	1.07	0.78	1.08	N/A	-319.0	23.8
Sofisedit	8.3	0.63	0.62	1.28	4.28	-24.3	0
Societe Generale de Banque au Senegal	0.5	0.06	0.65	2.12	5.42	209.3	42.7
Union Senegalaise de Banque	16.3	0.04	0.52	3.28	2.20	-526.9	45.0

Source: Individual banks' balance sheets.
(1) Two recent banks are not included because they began their activities following Sept. 1984: Caisse Nationale de Crédit Agricole and Sonaban
(2) Based on 1983 data. Defined as average interest earned minus average interest paid.
(3) Owned debt was not included in credit ceilings until March 1985.
(4) This bank began its activities in May 1983.

Source: Damon, Table 5,12

62

THE WEFA GROUP

SENEGAL

OCT 13, 1987

MACROECONOMIC VARIABLES

	80	81	82	83	84	85	86
GROSS NATIONAL PRODUCT, MILL US$	2870.3	2355.9	2453.7	2343.5	2164.5	2417.3	3546.6
GNP PER CAPITA, US$	503.6	400.9	412.0	372.2	340.7	377.6	NA
EXPORTS, FOB, MILL US$	477.0	500.1	547.9	1235.9	1268.0	996.3	NA
CURRENT ACCT. BAL., MILL US$	-442.1	-638.6	-505.5	-480.5	-402.3	-450.7	-368.0
TOTAL EXTERNAL DEBT, MILL US$	970.0	1018.5	1250.2	1507.7	1540.1	2001.9	NA
CONSUMER INFLATION, 1980=100	100.0	105.9	124.3	138.7	155.1	175.2	186.4
US$/FRANC, PERIOD AVERAGE	0.005	0.004	0.003	0.003	0.002	0.002	0.003
POPULATION, MILL.	5.7	5.9	6.0	6.3	6.4	6.4	NA

MONETARY SURVEY

	80	81	82	83	84	85	86
MONEY SUPPLY, M2, BILL. FRANCS	117.7	215.9	238.1	266.8	276.6	283.3	NA
CONSUMER INFLATION, 1980=100	100.0	105.9	124.3	138.7	155.1	175.2	186.4
WHOLESALE PRICE INDEX,1980=100	NA	NA	NA	NA	NA	NA	NA
DISCOUNT RATE	10.5	10.5	12.5	10.5	10.5	10.5	9.5
COMMERCIAL PRIME RATE	NA	NA	NA	NA	NA	NA	NA
GOVT. BOND YIELD, MEDIUM TERM	NA	NA	NA	NA	NA	NA	NA
DEGREE OF MONETIZATION	NA	NA	NA	NA	NA	NA	NA

854

SENEGAL

CONSOLIDATED BALANCE SHEET OF
DEPOSIT MONEY BANKS
BILLION FRANCS

	80	81	82	83	84	85	86
ASSETS							
RESERVES	10.1	11.7	21.9	21.2	24.2	22.4	NA
FOREIGN ASSETS	13.0	12.4	18.6	18.8	19.4	15.8	NA
CLAIMS ON GOVT.	15.6	14.5	13.5	13.5	14.9	14.5	NA
CLAIMS ON PRIVATE SECTOR	260.1	312.1	337.8	354.2	352.1	371.2	NA
LIABILITIES							
DEMAND DEPOSITS	82.0	85.1	98.7	106.1	109.6	103.4	NA
TIME AND SAVINGS DEPOSITS	40.0	53.7	73.3	84.0	95.5	106.6	NA
FOREIGN LIABILITIES	35.0	35.8	38.3	30.9	47.7	52.0	NA
GOVT. DEPOSITS	13.6	19.0	15.1	16.4	18.8	17.5	NA
CREDIT FROM CENTRAL BANK	107.6	146.9	169.6	175.3	156.0	182.1	NA
CAPITAL ACCOUNTS	NA	NA	NA	NA	NA	NA	NA
VALUATION ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
OTHER ITEMS, NET	11.1	-1.5	-16.4	-18.5	-30.6	-45.3	NA

BALANCE SHEET OF CENTRAL BANK

	80	81	82	83	84	85	86
ASSETS							
FOREIGN ASSETS	1.8	2.5	3.8	5.1	1.8	1.9	NA
CLAIMS ON GOVT.	36.8	59.6	116.2	132.3	145.3	158.2	NA
CLAIMS ON OFFICIAL ENTITIES	NA	NA	NA	NA	NA	NA	NA
CLAIMS ON COMM. BANKS	NA	NA	NA	NA	NA	NA	NA
CLAIMS ON SPECIAL BANKS	108.1	146.7	168.6	173.8	157.9	179.7	NA
LIABILITIES							
RESERVE MONEY	62.0	85.8	106.7	103.1	102.1	108.2	NA
OF WHICH							
CURRENCY OUTSIDE BANKS	51.4	73.6	84.5	78.3	77.3	86.2	NA
QUASI-MONEY DEPOSITS	NA	NA	NA	NA	NA	NA	NA
FOREIGN LIABILITIES	67.2	112.3	157.0	191.7	198.8	224.6	NA
CAPITAL ACCOUNTS	NA	NA	NA	NA	NA	NA	NA
RESCHEDULING ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
VALUATION ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
OTHER ITEMS, NET	4.6	4.5	4.5	0.4	-9.5	1.0	NA

255

SENEGAL

GOVERNMENT FINANCE
BILLION FRANCS

	80	81	82	83	84	85	86
DEFICIT(-)/SURPLUS(+)	-28.9	-74.6	-52.3	-73.3	-44.7	-38.1	-28.1
REVENUE	143.8	132.2	160.6	180.9	201.6	216.1	237.9
EXPENDITURE	172.7	206.9	212.9	254.2	246.3	254.2	266.0
FINANCING							
DOMESTIC	8.8	45.4	87.2	36.0	61.2	41.3	45.0
FOREIGN	69.2	121.7	92.0	146.5	109.3	136.9	92.7

INTERNATIONAL DEBT
MILL. US$

	80	81	82	83	84	85	86
TOTAL EXTERNAL DEBT, (EDT)							
LONG-TERM DEBT	970.0	1018.5	1250.2	1507.7	1540.1	2001.9	NA
PUBLIC AND PUBLICALLY GUARANTEED	961.0	1005.7	1237.4	1496.9	1530.4	1989.3	NA
PRIVATE NONGUARANTEED	9.0	12.8	12.8	10.8	9.7	12.6	NA
USE OF IMF CREDIT	97.9	147.8	184.0	196.6	200.8	241.1	NA
SHORT-TERM	219.0	237.0	202.0	192.0	260.0	211.0	NA
TOTAL LONG-TERM DEBT							
DEBT OUTSTANDING AND DISBURSED	970.0	1018.5	1250.2	1507.7	1540.1	2001.9	NA
DISBURSEMENTS	319.7	224.4	284.1	320.1	203.9	222.4	NA
PRINCIPAL REPAYMENTS	126.8	50.9	11.8	18.0	34.8	49.7	NA
NET FLOWS	192.9	173.5	272.3	302.1	169.1	172.7	NA
INTEREST PAYMENTS	57.0	42.8	34.2	41.3	51.5	44.4	NA
NET TRANSFERS	135.9	130.7	238.1	260.8	117.6	128.3	NA
TOTAL DEBT SERVICE	183.8	93.7	46.0	59.3	86.3	94.1	NA
PRINCIPAL RATIOS							
TOTAL EXTERNAL DEBT							
EDT/XGS)	144.5	177.7	243.0	257.1	267.7	273.3	NA
EDT/GNP)	44.8	59.3	66.2	80.9	91.8	101.5	NA
INTERNATIONAL RESERVES	25.2	20.2	24.6	23.3	12.6	14.6	NA

H. SOMALIA

1. MACROECONOMIC SURVEY

A. Introduction and Discussion of Key Problems

Somalia is one of the poorest countries in the world. Its growth prospects are severely constrained by the paucity of natural resources, an unbalanced economy dominated by livestock production, a primitive infrastructure, and a scarcity of skills.

Beyond these natural constraints to Somalia's growth are constraints that can be said to be "policy-induced", in the sense that they have been brought about by past or current policy failures, which have resulted in a highly inefficient use of resources. Foremost among these problems are high inflation, a heavy debt burden, and domestic and external financial imbalances.

With the support of the donor community, the Somali government embarked on a major reform program following a Consultative Group meeting held in 1983. The two main objectives of the reform program were:

(1) The achievement of financial stabilization, and

(2) Encouraging greater market orientation, with a view to attaining economic adjustment and growth.

The government's commitment to the program was uncertain, especially as the ban imposed by Saudi Arabia of imports of Somalian livestock had a devastating effect on the livestock sector and on government revenue. On the whole, however, the government did make an attempt to introduce some liberalizing measures as early as 1984, to very good effect. In particular, real GDP growth in 1984 and 1985 was estimated at 3% to 6% per annum. This was largely achieved as the key accomplishments of the reform program (the phasing out of agricultural prices and marketing controls, the liberalization of foreign trade, and a gradual but substantial devaluation of the official rate) combined with favorable weather to bring about a recovery of livestock and crop production and exports.

As the sharp rebound in inflation compelled the government eventually to take steps to moderate domestic credit expansion in 1985, domestic inflation dropped from 92% in 1984 to 37% in 1985, the result of moderating domestic credit expansion. The trade deficit narrowed somewhat as export revenues increased, while the import bill shrank due to higher domestic food production, and debt relief (to the tune of $150 million in 1985) reduced balance of payment pressures.

Problems did, however, persist in 1984 and 1985, and these continue to plague the economy to this day. In particular:

257

- There is general agreement that, while the government can report some successes with its reform program in 1984 and particularly in 1985, period, these reforms have not gone far enough. Some price and marketing controls remain in the agricultural sector (particularly for hides and skins, myrrh and frankincense), and in some public enterprises.

- The poor performance of industrial public enterprises is perhaps one of the most critical problems besetting the economy; the government's failure to carrying out its commitment (articulated in 1984) or revamping the public sector implies that the latter continues to constitute a serious drain on the budget and the economy.

- The budget deficit also remains large, and has indeed grown in 1986, a consequence of slow growth in domestic revenues and the mushrooming of development expenditures.

- The rate of expansion of broad money (M2) accelerated sharply in 1985, prompted by the increase in private sector foreign currency holdings and their steep revaluation as the Shilling tumbled. This has hampered progress in curbing inflation since 1985 (the inflation rate remained almost unchanged at 37% in 1986).

- Despite some improvement in the trade balance in 1985, the concommittant decline in workers' remittances (a result of shrinking employment opportunities in the oil-exporting countries) has prevented the current account from registering much improvement.

- The persistent current account deficit is making it difficult for Somalia to meet its debt obligations - despite some debt relief from donors. Over $170 million of arrears had accumulated as of the end of 1985, and total debt servicing is over 100% of expected export earnings.

In essence, then, the reform process begun in 1984 has had some positive impact, although that impact has tended to be limited and short-lived. This was largely the result of two factors: the imbalances fostered by long mismanagement are too deeply entrenched to be remedied speedily, and the government has not been willing or able to go far enough toward adopting the necessary administrative reforms. As of the end of 1986, the fiscal and current account deficits appeared as unwieldy as ever, and problems induced by government policy remained intractable, as poor public sector performance and the persistence of some controls perpetuated the misallocation of resources and continued to constrain growth.

Implications of Key Problems for the Financial Sector

Given the critical condition of the economy as a whole and the mixed (and so far hardly promising) overall policy

258

performance in the past two years, the prospects for the financial sector, and the role it can play in the development process, are rather difficult to define. On the one hand, it is fairly evident that the inadequacy of the financial sector is one of the key factors underlying the misallocation of resources. On the other hand, the need for massive restructuring, and the certainty that such restructuring will of necessity entail a lengthy transitional period, imply that far-reaching financial sector reform will be problematic for some time.

On the whole, the economic problems alluded to above necessarily imply the following constraints on the financial sector:

- Low per capita income levels have resulted in a level of gross domestic savings that, on the average, has been negative. This naturally constrains the financial sector's abilities to mobilize domestic resources.

- High inflation rates, coupled with unrealistically low nominal deposit rates due to interest rate ceilings, have translated into negative real returns on bank deposits. This has generally encouraged consumption at the expense of savings, and also made the acquisition of real assets (including consumer durables) a preferable option to holding Shilling-denominated financial liabilities for most surplus units.

- Even in the absence of interest rate ceilings, the persistence of high inflation the magnitude of which is difficult to predict implies a high, if not prohibitive, liquidity premium. In fact, both lenders and borrowers show a distinct aversion to medium- or long-term credit under such circumstances.

- The high financing needs of the government and of the parastatal sector have led to the diversion of a major portion of available credit to the public sector. This is a direct result of the government sector's monopoly over financial intermediation.

- The diversion of substantial resources to public investment, coupled with the failure of the public sector to utilize adequate profitability criteria in selecting projects, implies that funds are systematically misallocated.

This state of affairs suggests that substantial restructuring of the economy is needed before the financial sector can be expected to contribute effectively to the development process. At the same time, the very urgency of need for massive restructuring calls for the definition of a well-ordered reform of the financial sector, so that the latter can play a role in facilitating the overall macroeconomic policy reforms. Certainly, a number of preliminary financial sector reforms (notably the establish of one or more private bank to improve services to the private sector and to initiate a process of proper credit allocation) can be contemplated at an early stage.

This study proposes examine the overall structure of the financial sector in Somalia, the regulations to which the sector is subject and the role it currently plays in the economy. In the process the key problems emanating from these three areas will be highlighted, as will the role of the informal sector in the economy and the extent to which it is affected by financial intermediation. This will be followed by a discussion of the impact on the financial sector of the government's fiscal and monetary policy in recent years, as well as the major donor-coordinated restructuring programs attempted by the government over the same period. The extent to which financial sector reform can play a role in stabilization policies, and the extent to which it is constrained by the uncertainty to which they subject the economy, will thus be gauged. Finally, the prospects for financial sector reform will be evaluated, and the proper sequencing of such reforms in the context of an overall structural adjustment program will be discussed.

2. FINANCIAL SECTOR

a. Institutions

Somalia has a relatively primitive financial system, consisting of the National Commercial Bank of Somalia, the Somali Development Bank (SDB), the State Insurance Company of Somalia, and the postal savings system. All of these institutions are 100% publicly owned.

The two institutions specializing in the provision of credit to the private and public sectors, the National Commercial Bank and SDB, do not compete with each other in any significant way. Rather, their roles are for the most part mutually complementary, with the National Commercial Bank specializing in short-term credit, foreign currency exchange and the issue of letters of credit, and the SDB limiting its role to providing long-term financing for investment purposes.

The assets held by the National Commercial Bank of Somalia have undergone steady expansion since the beginning of the current decade. Loans to the private and public sector have grown more or less steadily, a development attributable to high inflation, and, in the light of trade liberalization in the mid-1980s, the growing need for short-term credit to finance trade-related operations by the private sector. The provision of letters of credit to traders and foreign currency services to exporters, who are allowed to retain half their foreign currency earnings after selling the other half to the Central Bank, has proven to be a highly profitable business, requiring minimal risk-taking and entailing substantial returns, especially as the National Bank is able to charge high fees for its services without fear of competition.

At the same time, quantitative controls on credit and, more importantly, ceilings on loan rates, are discouraging the bank from extending credit to other sectors than trade, where the effective return is supplemented by fees charged on services. This is evidenced by the fact that total cash and deposits held by the National Commercial Bank amounted to 16.2% of outstanding demand and time and savings deposits combined, well in excess of the 10% reserve requirement to which all deposits are now subject.

On the liability side, the rapid growth in loans over recent years has been paralleled by an equally remarkable growth in deposits. Given that deposit rates on time and savings deposits are subject to ceilings which have implied that they are well below the rate of inflation, the growth in time and savings deposits has tended to be somewhat slower than that in demand deposits, where the fact that no interest is paid is compensated by the ease of withdrawal; also, the existence of substantial excess reserves and the fact that demand and time and savings deposits are subject to the same reserve requirement have removed any incentive for liability managment by the bank, which consequently prefers borrower to hold non-interest-bearing checking accounts.

The Somali Development Bank provides long-term credit for investment purposes. The two broad sectors toward which SDB loans are primarily directed are industry (including salt works) and agriculture (defined to include livestock). Thru 1985, agriculture tended to account for the largest number of approved loans, but industrial schemes accounted for the largest relative share in the volume of credit. The share of agriculture of total SDB credit has, however, been steadily increasing at the expense of that of industry; thus the%age of total SDB credit extended to agriculture rose from 18.2% in 1982 to 36.2% in 1985, while that the percentage extended to industry dropped from 79.1% in 1982 to 49.6% over the same period. This has largely stemmed from the important role that livestock and crop production schemes have played in the reform programs implemented over that period, especially as trade and price liberalization encouraged greater private sector investment in livestock and crops. Indeed, it is estimated that in 1986 approved loans to agriculture significantly exceeded those to industry in 1986. (See Table I).

As far as the geographic distribution of loans is concerned, SDB's credit policy has shown a distinct preference for regions that are close to their headquarters at Mogadishu and, to a lesser extent, to their branch offices in Kisimayo and Hargeisa. Thus loans to Benadir, Middle and Lower Shabella, all close to Mogadishu, accounted for the lion's share credit, followed by loans to the Lower and Central Jubba, served by the Kisimayo branch, and loans to Northwestern region served by the Hargeisa branch. While the activity of the Kisimayo and Hargeisa branches has resulted in credit not being too heavily concentrated in the immediate vicinity of Mogadishu, it is obvious that SDB has had limited success in redressing the geographic imbalance that has

long been an economic fact of life. This stems partially from poor communications and the difficulty of gathering reliable information about projects in the remote regions, but more importantly it reflects the centralized focus of the public-sector-dominated economy.

b. Regulatory Environment

The Central Bank has a long way to go before it can establish itself as a credible regulatory agent. This stems in part from the vagueness of its role as a government body overseeing a system which is wholly government owned and which extends credit more to the government and public sector enterprises than to the private sector. Given the huge fiscal deficit, the likelihood of the Central Bank maintaining an independent monetary policy is negligible. Furthermore, the Central Bank's control of the money supply is diluted by the existence of substantial private sector foreign currency accounts, whose value has been dramatically boosted by the rapid depreciation of the Shilling, and by the accumulation of counterpart funds from the commodity aid program.

Despite the government's nominal commitment to privatization and the phasing out of controls, the financial sector remains subject to stringent controls that make it nearly impossible for the financial sector to promote private sector investment. Financial sector regulations can be divided into three groups:

- Regulations pertaining to entry into the market: As mentioned earlier, government-owned institutions exercise a complete monopoly over financial intermediation in the formal sector. While the government, under pressure from the donor community, has declared private bank to be legal, the appropriate legislation for setting up a private bank is still pending. The lack of a privately owned bank, and the general lack of competitiveness in the banking sector, is largely responsible for the poor level of financial services available to private investors, and the near-impossibility of obtaining financing for private sector schemes promising a high rate of return.

- Regulations pertaining to interest rates: The interest rate structure has been revised a number of times since 1981 (see Table II). On the whole, while nominal deposit and credit rates have been raised, they remain substantially below the inflation rate, which peaked at 92% before subsiding at around 38% in 1985. On the deposit side, negative real interest rates remove the incentive for saving, making it difficult for the financial sector to mobilize resources from the surplus units in the economy. On the lending side, negative real interest rate imply a subsidy for those who are able to borrow. Since the system is heavily biased toward government and parastatal lending, the system is basically doing little more than monetizing the public sector deficit. Meanwhile the private sector suffers from a severe credit shortage.

262

- Regulations pertaining to reserve requirements: Reserve requirements have not been altered since April 1970. The required reserve ratio on both demand and savings deposits is 10%. Since the National Commercial Bank, the only institution acting as a commercial bank, maintains reserves well in excess of 10% of total deposits, the reserve requirement is essentially meaningless and has no value as a tool of monetary policy.

c. The Role of the Financial Sector in the Economy

There is clear evidence that the financial sector in Somalia is grossly inadequate. This is due to a number of factors, namely:

- Interest rate ceilings on deposits make it difficult for the financial sector to mobilize domestic savings.

- The fact that the banking sector is wholly controlled by the government, and that poor management has resulted in large public sector deficits, necessitates the diversion of credit away from viable private sector enterprises and toward less efficient government entities and public sector enterprises.

- The standards of management at state-owned financial intermediaries leaves much to be desired. There is no systematic way of ranking investment opportunities; indeed it appears that cronyism and government pressures on financial institutions have resulted in systematic misallocation of funds.

- The lack of competition has resulted in a relatively poor quality of services and, in some instances, excessive fees on these services. This is particularly true of services like foreign currency transactions and letters of credit, which are largely the domain of the private sector.

- The lack of good communications and adequate information on less densely populated areas, and the centralized pattern of public sector administration, encourage the concentration of commercial bank operations at the capital or at key provincial cities. This has made banking services (particularly bank credit) largely unavailable in remote areas which are badly in need of funds for development.

An examination of the sources and uses of commercial bank funds will demonstrate the extent to which the system has failed to channel funds to areas where they can be profitably invested, which in effect has exacerbated the macroeconomic imbalances from which Somalia is suffering. On the deposit side (see Table III), the private sector accounted for 82.2% of total current account (demand) deposits, 87.5% of total time deposits, and 87.0% of total "free" (non-term savings) deposits as of September 1985, the last month for which reliable figures are available. Looking at the distribution of bank claims, however, we can see that the

government alone account for 52.5% of total bank credit, public entities for 12.7%, and the private sector for no more than 34.8%.

As far as sectoral balance is concerned, an examination of the distribution of bank credit among sector will show how sectoral and macroeconomic imbalances are aggravated by bank credit policies. As of September 1985, fully 70.0% of total bank loans and advances were to the trade sector, compared with 12.7% to livestock, 1.1% to agriculture, 2.8% to industry and crafts, and 13.4% to other activities. (Table IV shows that seasonality plays a negligible role in determining the distribution of bank credit.) This strong predilection for trade loans, which incidentally was spurred by the trade liberalization measures enacted in 1984, reflects the fact the trade sector is regarded by the banking sector as the most lucrative at present; also, bank officers often have ties in business circles which are heavily engaged in trade. From the point of view of efficient resource use, however, these loans do little to boost productive capacity, to improve income distribution or to diversify the country's resource base.

d. The Informal Sector

Given the tight restrictions to which the economy has been subject, the complex exchange rate regime and the lack of formal financial intermediation services in many areas, it is not surprising that the informal sector should play a significant role in the economy. Unfortunately, data about that sector are generally lacking, and what information is available to the donor community appears to be sketchy. This is a serious limitation, as it would be a grave omission to consider the role of the financial sector and the prospects for reforming it without taking the informal sector into consideration.

That a large informal sector exists in Somalia is something of which most experts are convinced. Perhaps the clearest evidence of that can be gleaned from Table IV, which shows that the magnitude of loans going the livestock sector at the time of Adha Feast, which roughly coincided with August in both 1984 and 1985, was not significantly above the average monthly level in both years. Since it is known that the Adha Feast is when fat-tail sheep (the only kind that Saudi Arabia still imports) are exported to Saudi Arabia in large quantities, it is evident that livestock producers rely on other credit than that provided by the banking system.

Another financial activity for which there is a huge informal or underground sector is foreign exchange transactions, as well as many import operations financed by these transactions. The current foreign exchange regime in Somalia is one of the most problematic features of the economy. The official rate of Sh 92 per U.S. dollar is used for government transactions and -- although this is soon to be discontinued -- for payment to

264

exporters on the 50% of their foreign exchange earnings that they must surrender. An auction rate (estimated at present at some Sh 120 per U.S. dollar) is currently being set up in conjunction with an IMF program; the use of foreign currency purchased at that auction is subject to certain restrictions. There is also a "free" rate (of about Sh 140 per U.S. dollar) that is negotiated on a one on one basis between buyer and seller, the foreign currency thus obtained being used mostly for imports. Finally there is the black market rate, which is currently estimated at Sh 145 to 150 per U.S. dollar, and which is most commonly used for capital flight.

The informal sector is guaranteed a major sector of foreign exchange transactions for a number of reasons. First, as many Somalis work abroad (primarily in oil-producing countries), the remittances they send abroad are often diverted to the black market, where the workers' families can obtain the highest rate. Second, exporters are at present allowed to retain 50% of their foreign exchange earnings, the remainder being traded at the free or black market rate. This system functions quite smoothly and at least has the advantage of providing foreign exchange to those private enterprises able to pay the most for foreign funds, but the process entails substantial costs (since third parties are almost invariably used). More importantly, it makes it difficult to mobilize resources for investment purposes; foreign funds obtained in this manner tend to be used to obtain consumer imports.

3. GOVERNMENT POLICIES AND THEIR IMPLICATIONS FOR THE FINANCIAL SECTOR

a. Fiscal Policy

There was a modest improvement in the budgetary situation in 1985, as total revenue increased 35% in nominal terms after declining 8% in 1984. Still, the nominal increase in 1985 was well below the rate of inflation, and the current budget actually increased that year as recurrent expenditures expanded. The large current budget deficit continues to be a serious problem, draining resources and ultimately derailing the goal of stabilizing the economy. Underlying the large current deficit are two critical factors:

(1) The slow growth in the government's domestic revenues, and

(2) The continued expansion of expenditures.

The situation is made worse by the large size of development expenditures relative to the recurrent budget, especially as the new development projects (PIP) imply significant recurrent costs, which are not incorporation into public investment planning. This under funding of recurrent expenditure has led to poor maintenance and a deterioration in physical facilities and public

265

services, especially as general services (including defense) accounted for 88% of the budget in 1985, leaving only 12% for economic and social services. This is an extremely low percentage compared to the overall sub-Saharan African average of 37%.

This serious fiscal imbalance has dire implications for the financial sector and the role it can play in the development process. First, the large size of the fiscal deficit implies that, even given substantial foreign aid, significant domestic borrowing is needed. In the absence of developed financial markets, the only source of borrowing is the banking sector. This state of affairs leaves little funding for private sector investment, given the difficulty of mobilizing savings. Also, to the extent that the public sector deficit is ultimately monetized by the financial sector (including the Central Bank), inflation cannot be eradicated, with obvious implications for real interest rates. Second, since the financial sector funds the public sector deficit without having much say in the allocation of funds to projects, there is little chance that the financial sector will develop credit evaluation expertise along sound financial lines.

b. Monetary Policy

The persistent dissaving by the government and the impossibility of closing the domestic savings investment gap entirely through foreign transfers implies a need for continual expansion in domestic credit, which amounts to little more than an expansion of the money supply enabling the government to appropriate resources through inflation in lieu of tax collection.

Domestic credit has grown substantially in since the beginning of the decade, generating significant inflationary pressure. As can be seen from Table V, the expansion in claims on the government and on the public sector account for a significant portion of the growth of domestic credit. Attempts were made to curb credit expansion and control inflation in the context of the donor-coordinated reform program adopted in 1984. Success has been less than impressive, however. Central Bank financing of the deficit fell from Sh. 2.6 billion in 1984 to Sh. 900 million in 1985, which reduced the rate of expansion of total domestic credit to 18% in 1985 compared with over 82% in 1984. This did little to improve the overall distribution of credit between sectors; the rate of growth of credit to public entities increased somewhat in 1985, while the rate of growth of credit to the private sector fell dramatically from 62% in 1984 to 8% in 1985. Inflation fell to 38% from 92% in 1984, but negligible progress was made in 1986, as the money supply continued to grow rapidly -- spurred by the revaluation of private sector deposits in shilling terms, which began in 1985 -- and inflation remained almost unchanged at 37%. Meanwhile the share of the private sector in domestic credit continued to fall.

The primitive state of the financial sector makes it extremely difficult to pursue a meaningful monetary policy. The basic tools of monetary policy are absent in Somalia: the reserve requirement is not a binding constraint given the size of excess reserves; the discount rate is meaningless given that it, too, is lower than inflation and given the excess reserve situation; and there is no possibility that debt instruments issued by the government could have a secondary market, when the return on financial instrument is lower than the rate of inflation. Until a far-reaching stabilization program, incorporating a phased-in reform of the financial sector, is implemented, the role of the monetary authorities will be limited to validating inflationary spending by the public sector.

c. Structural Adjustment Programs

Somalia's record with adjustment programs is mixed. On the whole, the government has shown itself willing to adopt basic reforms in order to secure debt relief. All too often, however, the reforms were poorly coordinated, did not go far enough in some areas, and did not survive very long. Financial discipline, in particular, has proven elusive; despite repeated promised to revamp the public sector, the government has done little to rationalize public sector spending or to improve the productivity of public investment.

The decade began promisingly enough as the government exercised considerable fiscal restraint in 1981 and 1982, reducing spending and public borrowing in both years. This caused the budgetary deficit to decline somewhat, and also reduced inflationary pressures. While the budget deficit increased in 1983, foreign borrowing made it possible for the government to reduce borrowing from the domestic banking system.

Although the government committed itself to a reform package following the meeting of the Consultative group in 1983, the government's commitment proved ephemeral. By 1984, the pressure on the government brought about by the 1983 ban the Saudis imposed on most imports of livestock from Somalia (ostensibly because of rinderpest problems) caused it to suspend implementation of the IMF program, at least as far as expenditure control was concerned. Instead of cutting back on spending, the government resorted to large-scale domestic borrowing which led to record inflation and further exchange rate distortions.

By 1985, however, the deterioration in the economic and financial situation prompted the government to adopt a major adjustment program under a new stand by agreement with the IMF. The aim of the program is to reduce inflation and fiscal and external imbalances through demand control and improved resource allocation. The key ingredients of the program are:

267

- Continued devaluation and the establishment of a free exchange market for most private sector transactions
- The removal of most restrictions on imports and exports
- The dismantling of price controls
- The reduction of government spending

As mentioned above, the government's record in implementing these reforms has been mixed. It is now clear that the adjustment process will be slow and difficult, the risk of slippage being considerable. At present, while inflation may be at least below the record levels of 1984, external and fiscal imbalances persist, and stabilization cannot be said to have been achieved yet.

USAID has funded a number of projects connected with the government's restructuring and stabilization efforts. Of these one has major implications for the financial sector: the Policy Initiatives and Privatization (PIP) Project, for which funding to the tune of $2.5 million was authorized in late September 1983. The project is intended to promote the twin goals of providing the information and analyses needed by the USAID mission and the government to engage in policy dialogue and reform, and to promote private sector development. A major element in the plan to promote private sector development is funding for a private bank with foreign participation, for which the PIP project has set aside $1.5 million. The IFC is currently working with a group of Somali and foreign investors on the establishment of such a bank.

There is no doubt that the setting up of a private bank in Somalia would be a highly positive development. Such a bank would insure:

- greater competitiveness in the banking sector,
- improved services to the private sector, and
- a better allocation of credit.

However, while the government has given pro forma approval for setting up such a bank, it has been dragging its feet on issuing the necessary legislation. The problem may have stemmed partially from the fact that a proposal competing with the IFC group's was submitted to the government by a group of investors for an Islamic bank in Somalia, presumably with funding from the Saudis. More to the point, however, the government is believed to be reluctant to alter the current situation in the banking sector because:

- The monopoly the government enjoys over banking enables it to accrue substantial revenues from inflated fees on services to the private sector

- The creation of a private bank with foreign participation may diminish the government's ability to control the expansion and distribution of credit

- Most importantly, the organization of the public sector (including publicly owned financial institutions) in many ways mirrors the political structure of the country, with various political figures and their allies maintaining power bases through their control of specific institutions. It would be difficult to introduce a novelty like a private bank without upsetting the existing balance of power, with possibly dangerous consequences.

The government's evident reluctance to enact the necessary legislation is prompting USAID officials to consider re assigning the $1.5 million earmarked for a private bank. The consensus among USAID officials at the mission and in Washington appears to be that, while there is strong support for the idea in the donor community, the government's lack of interest renders it impractical.

4. CONCLUSIONS AND RECOMMENDATIONS

Major reforms are needed to increase the efficiency of the financial sector and enable it to play a more constructive role in the development process. These include:

- Increasing competitiveness in the sector by allowing a private bank to operate
- Phasing out interest rate ceilings with a view to attracting deposits
- Standardizing and tightening standards for credit allocation by financial institutions
- Strengthening the Central Bank as an agency independent of the government and able to play a major role in credit control and bank supervision
- Replacing quantitative explicit or implicit credit controls with tight reserve requirements, enabling the monetary authorities to control credit expansion

The fact remains, however, that it is premature to speak of introducing such reforms in today's climate. This is because:

- In the case of the most obvious and the most imminently needed reform, the setting up of a private bank, the government's resistance to the idea makes it impracticable.

- Caution must be exercised to insure that liberalization measures are introduced in the proper sequence. Thus it is futile to speak of "positive interest rates" in a financial environment so unstable that inflation can easily accelerate rapidly.

Clearly, priority should be given to policy reforms that begin to redress macroeconomic imbalances. The dismantling of remaining price controls, measures to enhance tax revenues, incentives for exporters, the rationalization of development spending, and civil service reform must be achieved in the

context of a long-term restructuring plan that is accompanied by substantial debt relief at its initial stages.

At the same time, the financial sector would benefit greatly from further study by USAID to consider:

- Ways to expedite necessary reforms. In particular, a study of the structure of the administration and how that affects the government's attitude to the notion of a private bank would be highly desirable.

- Aspects of the financial sector and of the economy on which little information is available. This is particularly true of the informal sector, on which information is sadly lacking. The kind of information that must be gathered about the sector includes:

  - Its relative size and importance to the economy.
  - The geographic areas and sector in which it is most important.
  - How informal financial intermediation functions, and how its efficiency compares with that of the formal financial sector.
  - What impact financial sector and other reform would have on the efficiency of the informal sector in general and on informal credit markets in particular.

BIBLIOGRAPHY

"Customs Tariff of the Somali Republic: Legislative Decree no. 5 of 11 December, 1968", Ministry of Finance, Mogadishu, Somalia (1968)

"Financial Statements... and Report Thereon by the Accountant General = Conto Consuntivoe... e Relativo Rapporto Redatto dal Ragioniere Generale", Ministry of Finance, Mogadishu, Somalia (1969-1971)

IBRD, "Somalia: Recent Developments and Medium-Term Prospects", IBRD (Washington, D.C.: 1987).

IBRD, "Somalia: Recent Developments and Medium-Term Prospects", Manuscri (Washington, D.C.:1987).

IBRD, "Somalia: Towards Economic Recovery and Growth", Manuscript (Washington, D.C.: 1985).

IMF, "Government Finance Statistics Yearbook. Extract: Somalia", IMF, Washington, D.C. (annual)

Lingappa, Shiva, "Education and the Socio-Economic Environment: Recent Developments in Somalia", UNESCO, Paris (1977)

"Short-term Development Program, 1968-1970", Planning Commission, Mogadishu, Somalia (1968)

SRI International, "The Policy/Regulatory Environment for Private Invest in Somalia", Manuscript (Arlington, VA: 1986).

"Uniform Annual Plan: Budget System for Public Enterprises; Operating Guidelines", Ministry of Industry, Mogadishu, Somalia (Jan., 1983)

Table I

APPROVED LOANS PER ECONOMIC SUBSECTOR
(Amounts in million ShSo)

Sectors	1982			1983			1984			1985		
	No	Amount	%	No	Amount	%	No	Amount	%	No	Amount	%
Industry*	36	38,6	79,1	33	45,7	56,4	28	118,5	61,6	30	327,8	49,6
Agriculture**	118	8,9	18,2	87	18,6	22,9	150	65,9	34,3	162	239,3	36,2
Fisheries***	-	-	-	2	0,9	1,1	4	6,2	3,2	6	50,7	7,6
Services	4	1,3	2,7	7	15,9	19,6	4	1,8	0,9	7	43,5	6,6
Total	158	48,8	100,0	129	81,1	100,0	186	192,4	100,0	205	661,3	100,0

* Industry includes salt works
** Agriculture includes livestock and crop production
*** Fisheries is mentioned separately because of it's growing importance

Source: Central Bank of Somalia

Table II

INTEREST RATES STRUCTURE
IN FORCE FROM JANUARY 1, 1985

Interest Rates on credits	%	Interest Rates on Deposits	%
CENTRAL BANK			
- Official discount rate	12.0	Ordinary Savings	12.0
- Government credits	12.0	Time Savings 3 Months	14.0
		" " 6 "	15.0
		" " 12 "	16.0
		" " 24 "	17.0
		" " Over 24 "	18.0
COMMERCIAL BANK			
- Credit to co-operatives and small-scale farmers & Exporters	15.0		
- Credit to Public Enterprises	19.0		
- Credit to Foreign Enterprises	20.0		
- Other credits	19.0		
DEVELOPMENT BANK			
- Medium-term (2-6 Y.) Loan to Agri.& Handcrafts	14.0		
- Medium-term (2-6 Y.) Loan to Industry & Mining	15.0		
- Medium-term (2-6 Y.) Loan to Others	16.0		
- Long-term (7-20 Y.) Loan to Agri.& Handcraft	15.0		
- Long-term (7-20 Y.) Loan to Industry & Mining	16.0		
- Long-term (7-20 Y.) Loan to Others	17.0		

Source: Central Bank of Somalia

BANKING SYSTEM BANKING SYSTEM DEPOSITS Table III

End of Period	Current Account Deposits				Savings Deposits						GRAND TOTAL
					Time			Free			
	Public Entities	Private Sector	Financial Institutions	Total	Public Entities	Private Sector	Finan. Instit.	Public Entities	Private Sector	TOTAL	
Dec. 1978	420.2	252.2	25.6	698.0	43.5	82.2	11.8	11.5	169.9	318.9	1,016.9
Dec. 1979	513.6	452.5	12.8	978.9	66.5	133.3	2.0	21.2	254.6	477.6	1,456.5
Dec. 1980	519.0	456.7	34.8	1,010.5	92.0	154.9	3.2	20.9	326.9	597.9	1,608.4
Dec. 1981	290.0	1,009.5	10.2	1,309.7	27.8	232.5	7.3	3.9	475.6	747.1	2,056.8
Dec. 1982	349.3	1,364.1	8.1	1,721.5	107.5	252.4	5.3	-	649.0	1,014.2	2,735.7
Dec. 1983	223.9	1,713.4	16.1	1,953.4	164.1	205.2	6.7	42.3	634.2	1,19..5	3,144.9
Jan. 1984	449.2	1,765.5	15.0	2,229.7	122.6	305.7	5.7	33.6	845.3	1,313.2	3,542.9
Feb. "	457.1	1,663.2	21.4	2,341.7	122.9	392.5	5.7	35.3	800.7	1,357.1	3,698.8
March "	530.1	1,810.6	25.7	2,366.6	65.1	396.9	5.6	35.8	800.3	1,333.7	3,750.3
April "	497.3	1,962.2	4.9	2,464.5	179.1	388.7	5.6	35.9	900.0	1,509.3	3,973.9
May "	698.7	1,828.4	21.2	2,546.3	193.5	457.9	5.6	25.3	1,015.0	1,737.3	4,205.6
June "	797.7	1,930.5	22.6	2,750.8	164.7	426.3	4.2	25.7	1,028.2	1,669.1	4,419.9
July "	781.4	1,906.8	18.1	2,706.3	110.7	457.3	4.3	25.6	1,170.4	1,768.3	4,476.6
Aug. "	561.0	2,146.8	22.4	2,751.0	104.3	479.5	4.3	25.5	1,097.1	1,710.7	4,461.7
Sept. "	581.0	2,012.2	9.0	2,602.2	105.2	702.7	4.3	25.5	1,224.1	2,061.8	4,664.0
Oct. "	634.6	2,227.3	2.5	2,864.4	100.8	662.6	4.3	22.4	1,274.5	2,064.6	4,929.0
Nov. "	811.7	2,320.5	7.4	3,139.5	97.6	659.0	4.3	40.7	1,203.2	2,005.0	5,144.5
Dec. "	706.8	1,950.9	2.0	2,661.7	66.7	426.2	4.7	51.9	1,010.7	1,600.2	4,261.9
Jan. 1985	612.9	1,871.4	2.6	2,687.1	108.6	436.7	4.7	29.0	1,102.1	1,683.1	4,370.2
Feb. "	655.8	1,844.3	2.6	2,702.9	321.6	483.2	4.7	29.6	1,114.5	1,953.8	4,656.6
March "	763.2	1,876.0	56.2	2,695.4	418.3	529.6	4.7	29.2	1,153.5	2,133.3	4,833.7
April "	1,237.0	2,460.1	17.5	3,714.6	339.8	607.9	6.3	39.2	1,270.0	2,343.2	6,057.8
May "	1,133.7	2,882.2	26.4	4,042.3	339.4	673.9	6.3	39.3	1,292.0	2,358.6	6,392.9
June "	823.1	3,158.4	11.0	3,992.5	378.6	605.2	6.3	39.7	1,306.3	2,418.1	6,410.6
July "	754.8	3,578.5	21.6	4,352.9	339.5	665.4	6.3	41.6	1,185.6	2,284.4	6,637.3
Aug. "	832.7	4,430.3	0.4	5,263.4	295.7	733.4	6.3	46.5	1,542.2	2,626.1	7,889.5
Sept. "	971.9	4,533.1	8.2	5,513.2	102.5	764.6	6.3	227.5	1,526.1	2,627.0	8,140.2

Source: Central Bank of Somalia

BANKING SYSTEM

MONETARY SURVEY

(Millions of So.Sh.)

Table III cont'd

End of Period	(1) Foreign Assets (net)	Claims on (2) Private Sector	Public Entities	Govern't net	Total	Money supply (1) Money in Circulation	Demand Deposits A/Cs	Cheques Outstanding	(3) Total	Quasi Money	3 + 4 = Money Supply (II)	Other Items (net)
Dec. 1978	506.5	402.1	1,002.5	311.0	1,715.6	883.1	698.0	146.9	1,728.0	318.8	2,046.8	605.4
Dec. 1979	316.4	447.1	1,273.6	1,231.4	2,957.1	1,152.6	978.9	203.8	2,335.3	477.7	2,013.0	460.8
Dec. 1980	145.1	426.1	1,551.1	1,902.4	3,879.6	1,507.9	1,010.6	264.8	2,783.3	597.9	3,381.2	643.5
Dec. 1981	57.8	574.6	1,721.4	2,249.6	4,545.6	1,890.9	1,309.3	473.9	3,674.1	747.1	4,421.2	182.2
Dec. 1982	3.1	1,623.8	1,360.0	2,100.4	5,084.6	1,455.7	1,797.4	855.3	4,108.4	1,014.2	5,122.6	- 95.7
Dec. 1983	-1,873.2	2,292.8	1,163.0	1,805.0	5,260.8	1,355.5	1,953.3	1,000.5	4,309.3	1,191.5	5,500.8	-2,113.2
Jan. 1984	-2,066.7	2,304.6	1,103.0	1,849.3	5,337.9	1,442.9	2,229.7	1,075.7	4,747.9	1,313.3	6,061.2	-2,790.0
Feb. "	-2,094.0	2,440.0	1,055.3	2,376.0	5,671.9	1,515.8	2,341.7	1,165.0	4,983.5	1,357.0	6,332.5	-2,764.6
March "	-2,103.3	2,484.9	1,225.7	2,965.7	6,676.3	1,035.6	2,353.7	1,062.8	5,053.1	1,393.7	6,446.8	-2,934.3
April "	-2,704.0	2,536.4	1,292.5	3,084.3	7,013.3	1,520.4	2,464.6	967.0	5,052.0	1,409.5	6,561.5	-2,252.7
May "	-2,791.5	2,756.2	1,302.5	3,489.0	7,607.9	1,631.7	2,546.3	940.0	5,110.0	1,937.3	6,047.3	-2,000.9
June "	-2,659.4	2,824.4	1,450.6	3,415.7	8,070.7	1,720.0	2,750.8	818.5	5,359.5	1,669.6	7,029.3	-1,796.0
July "	-2,911.4	3,150.3	1,290.5	4,148.1	8,588.9	1,930.6	2,703.3	1,025.7	5,704.6	1,768.3	7,472.9	-1,795.4
Aug. "	-2,635.1	3,202.7	1,291.8	4,299.2	8,813.7	2,236.3	2,751.0	1,067.8	6,057.1	1,710.7	7,767.8	-1,639.2
Sept. "	-3,075.6	3,403.7	1,081.6	4,434.9	8,920.2	2,176.0	2,602.2	1,041.6	5,821.8	2,661.8	7,683.6	-2,039.0
Oct. "	-3,148.7	3,197.0	1,300.4	4,826.3	9,323.7	2,200.2	2,864.4	812.4	5,877.0	2,064.6	7,941.6	-1,766.3
Nov. "	-3,540.0	3,318.7	1,371.7	5,095.0	9,684.4	2,084.9	3,135.5	587.4	5,921.9	2,005.0	7,926.9	-1,662.5
Dec. "	-4,339.8	3,726.9	1,511.2	4,370.1	9,616.2	1,899.7	2,661.7	771.4	5,332.8	1,600.3	6,933.1	-1,656.7
Jan. 1985	-3,575.4	3,712.9	1,397.3	4,061.8	9,172.0	1,942.4	2,607.0	992.6	5,552.0	1,683.1	7,235.1	-1,630.5
Feb. "	-3,700.0	3,799.8	1,320.3	4,320.3	9,440.1	1,944.1	2,702.9	1,253.0	5,900.0	1,954.0	7,854.0	-2,107.8
March "	-3,511.6	3,853.2	1,399.4	4,415.4	9,668.0	1,924.0	2,695.5	1,120.2	5,750.7	2,138.3	7,889.0	-1,734.6
April "	-3,572.5	3,788.7	1,370.3	4,507.7	9,666.7	1,774.5	3,714.6	673.9	6,567.1	2,343.3	8,911.1	-2,816.9
May "	-3,551.2	4,070.0	1,211.6	4,516.9	9,808.5	1,970.8	4,042.3	637.0	6,651.9	2,350.7	9,002.6	-2,745.2
June "	-3,743.6	4,073.4	1,296.1	4,419.2	9,788.6	2,247.1	3,992.5	638.8	6,878.2	2,418.3	9,296.6	-3,251.6
July "	-3,601.5	4,111.6	1,315.4	4,737.1	10,206.3	2,645.4	4,352.9	529.7	7,527.0	2,284.5	9,811.5	-3,203.7
Aug. "	-2,669.1	4,112.2	1,357.1	5,346.1	10,815.4	3,008.5	5,263.4	544.9	8,896.9	2,626.1	11,523.0	-3,576.8
Sept. "	-2,527.5	4,013.1	1,463.5	6,049.0	11,525.6	3,336.5	5,513.2	623.8	9,673.5	2,627.0	12,300.5	-3,302.4

Source: Central Bank of Somalia

275

BANKING SYSTEM

LOANS AND ADVANCES BY BRANCHES OF ECONOMIC ACTIVITY

(Millions of So.Sh.) Table IV

End of Period	Agriculture (1)	Livestock	Industry & Crafts	Fishery	[illegible] Trade	Other (2)	TOTAL
Dec. 1978	204.5	104.5	255.6	15.1	775.1	49.8	1,404.6
Dec. 1979	192.1	120.3	330.5	15.8	1,051.8	48.5	1,759.0
Dec. 1980	166.2	141.2	469.1	27.9	1,047.7	125.0	1,977.1
Dec. 1981	274.5	227.5	566.4	21.0	1,098.6	103.9	2,291.9
Dec. 1982	300.8	376.6	606.3	32.7	1,378.9	72.9	2,848.2
Dec. 1983	165.4	474.4	449.6	21.2	2,214.9	130.3	3,455.8
Jan. 1984	252.0	577.8	574.9	43.4	1,905.4	135.0	3,488.5
Feb. "	106.8	601.5	551.3	43.4	1,973.6	139.3	3,495.9
March "	238.2	1,057.3	698.2	43.5	1,340.8	332.2	3,710.6
April "	321.5	613.7	545.4	21.2	2,076.2	349.0	3,929.0
May "	183.4	522.2	488.7	43.1	2,549.4	352.0	4,138.8
June "	173.9	307.0	325.4	44.3	3,020.7	383.6	4,254.9
July "	165.6	720.7	345.3	44.7	2,777.2	387.3	4,440.6
Aug. "	342.9	413.4	543.3	44.7	2,780.2	390.0	4,514.5
Sept. "	352.9	389.9	554.1	44.9	2,753.6	389.9	4,485.3
Oct. "	367.1	420.4	77.7	24.5	3,194.1	413.6	4,497.4
Nov. "	260.3	412.0	631.6	45.9	2,794.4	565.3	4,709.5
Dec. "	160.2	892.7	488.1	0.4	3,119.2	577.4	5,238.0
Jan. 1985	130.9	219.6	157.9	25.4	4,027.7	575.8	5,110.3
Feb. "	310.1	261.0	245.0	25.4	3,701.8	584.8	5,126.1
March "	300.0	399.9	244.1	26.4	3,652.1	629.9	5,252.4
April "	65.4	573.6	246.8	48.8	3,619.8	604.5	5,158.5
May "	64.3	600.8	318.4	83.2	3,636.6	586.1	5,289.4
June "	60.6	597.6	563.7	27.4	3,528.4	591.8	5,369.5
July "	68.6	388.9	111.1	34.6	4,184.4	639.5	5,427.1
Aug. "	80.2	848.6	132.0	219.9	3,502.9	685.6	5,469.2
Sept. "	61.5	694.7	154.8	16.2	3,831.5	715.8	5,476.5

1) From Jan. 1978 Includes special credit to banan

2) From Jan. 1978 includes credit to S.D. Bank.

Source: Central Bank of Somalia

216

Table V

SOMALIA: Money and Credit, 1980-86
(Mill. of So.Sh., end of Period)

Items	1980	1981	1982	1983	1984	1985	1986 [2]
Foreign Assets, Net[1]	145	72	-641	-2386	-4465	-5868	-8259
Domestic Credit	3886	4546	5624	5261	9616	11847	13686
Claims on Gov't., Net	1982	2258	2166	1865	4378	5252	6196
Claims on Public Entities	1551	1722	1386	1163	1511	2671	3257
Claims on Private Sector	426	575	1624	2293	3727	4924	4227
Money Supply (M1)	2783	3619	3911	4157	5878	9117	11837
Money & Quasi-Money (M2) [3]	3381	4366	4995	5349	6878	11968	16111
Other Items, Net [1]	643	251	-612	-2468	-1787	-6428	-10333
Memo Items							
Ratio of M2 to GDP	27.4	22.9	28.3	15.6	16.3	12.3	11.6
% Increase of M2	26.2	29.1	14.4	7.1	24.9	78.2	35.3
% Increase in DOM Credit	31.12	17.2	16.5	4.7	82.8	18.6	26.6
% Increase in Mogadishu CPI	59.6	44.6	22.6	36.4	92.1	37.9	37.6

1/ Includes valuation adjustments.
2/ Data for 1986 are as of September 1986.
3/ M2 includes money supply (currency and demand deposits) and time deposits.

Source: Central Bank of Somalia

Table VI

SOMALIA - Balance of Payments Summary, 1981-1985
(in millions of US dollars)

	1981	1982	1983	1984	1985
Exports, f.o.b.	114	137	161	62	93
Imports, c.i.f.	-422	-484	-456	-466	-362
Trade Balance	-308	-347	-349	-344	-269
Non-factor services (net)	9	23	24	-3	-6
Resource Balance	-299	-324	-325	-347	-275
Interest Payments	-10	-14	-21	-44	-43
Private Transfers (workers' remittance)	64	50	51	72	20
Current Account Bal.	-245	-288	-295	-319	-298
Official Transfers (net)	150	157	148	174	179
Public Loans (net)	79	123	100	46	69
(disbursements)	(93)	(131)	(107)	(106)	(114)
(repayments)	(-14)	(-8)	(-7)	(-60)	(-45)
Other Capital (incl. errors and omissions) (net)	3	-36	-39	-46	-38
Overall Balance	-13	-44	-88	-139	-88
Financing	14	44	86	139	88
Central Bank	33	64	47	13	28
of which: Net credit from IMF	36	34	44	-3	32
Commercial Bank	-26	-26	39	29	-32
Arrears	-	-	-	71	-58
Debt Relief	-	-	-	26	150
Memo Items:					
Gross reserves as % of total imports	18	3	4	1	2
Current account deficit/GDP (%)	-8.1	-12.6	-13.6	-9.8	-12.7
Debt service ratio (as % of exports of goods and services)					
accrual basis	20	21	23	168	184
cash basis	n.a.	n.a.	n.a.	19	48

Source: Central Bank of Somalia

Table VII

Somalia: Macroeconomic Balances, 1980-85
(Percent of GDP)

	1980	1981	1982	1983	1984	1985
Foreign Savings						
Current A/C Balance	-14.2	-8.1	-16.3	-13.6	-10.7	-21.7
Net imports (Resource Balance)	-17.0	-9.9	-17.9	-14.9	-11.6	-20.8
Private Sector						
Gross Dom Inv	-2.7	10.9	8.9	5.6	4.8	4.1
Fix Inv [1]	1.9	1.4	2.2	2.4	3.1	2.8
Chg in Stk [2]	-4.5	9.5	6.7	3.2	1.8	1.3
Dom Savings	-9.1	6.5	-2.2	0.6	10.5	-0.6
Inv - Sav	6.4	4.3	11.1	5.0	-5.7	4.8
Public Sector						
Gross Dom Inv	7.5	5.4	6.2	8.6	10.8	11.2
Fix Inv	7.5	5.4	6.2	8.6	10.8	11.2
Chg in Stk [3]	--	--	--	--	--	--
Dom Savings	-3.1	-0.2	-0.6	-1.4	-6.4	-4.9
Current Rev	11.5	11.9	11.2	12.4	6.1	5.4
Current Exp	14.6	12.1	11.8	13.7	12.5	10.3
Inv - Sav	10.6	5.6	6.8	10.6	17.2	16.0
Public & Private						
Inv - Sav	17.0	9.9	17.9	14.9	11.6	20.8
Memo Item						
Share of Gross Dom. Inv. financed by foreign savings (%)	100	94	100	100	96	100

1/ Split between public and private investment is taken from government document, "Performance of the Somali Economy, 1983", and staff estimates.

2/ Change in stock data primarily refer to livestock. Due to weak data base, may include some public sector stock changes.

3/ Included in private change in stocks.

Source: Central Bank of Somalia

Table VIII

SOMALIA: Summary of Central Government Finance, 1981-86
(In Mill. of Somali Shillings)

	1981	1982	1983	1984	Prelim 1985	1986*
Domestic Revenue 1	2262.6	2759.6	4252.5	3978.7	5226.6	9466.6
of which Tax Revenue	2067.3	2477.9	3463.5	2979.9	4582.4	8413.6
Recurrent Expenditure 1	2295.6	2905.6	4716.6	8146.6	9918.6	15393.6
Current Balance	-32.4	-145.4	-463.5	-4161.3	-4698.6	-5993.6
Development Expenditure	1424.8	2466.6	1926.6	3181.5	7946.6	12296.6
of which: Development Budget	285.8	347.6	498.1	661.5	1372.6	2666.6
Overall Balance	-1457.2	-2666.6	-2383.5	-7342.8	-12638.6	-18289.6
Financing	1457.2	2666.6	2383.5	7342.8	12638.6	18289.6
Foreign	1116.2	2780.6	2678.5	4726.3	11593.6	18356.6
Loans	681.2	1724.6	1572.5	2797.8	4973.6	9061.6
Grants	435.6	1056.6	1106.6	1986.6	6626.6	9349.6
Domestic	341.6	-174.6	-295.6	2565.6	1645.6	-61.6
Banking System	347.6	-156.6	295.6	2573.6	875.6	-61.6
Other	-6.6	-24.6	6.6	-8.6	176.6	6.6

1/ Includes transfers to and from local governments.

Source: Central Bank of Somalia

* estimates as of December 1986.

THE WEFA GROUP

SOMALIA

OCT 13, 1987

MACROECONOMIC VARIABLES

	80	81	82	83	84	85	86
GROSS NATIONAL PRODUCT, MILL US$	1086.8	1585.2	1726.6	NA	NA	NA	NA
GNP PER CAPITA, US$	271.7	377.4	401.5	NA	NA	NA	NA
EXPORTS, FOB, MILL US$	132.6	152.5	201.6	107.4	44.3	90.6	NA
CURRENT ACCT. BAL., MILL US$	-136.2	-83.4	-177.4	-141.6	-132.0	-96.6	NA
TOTAL EXTERNAL DEBT, MILL US$	714.1	1026.6	1151.7	1236.2	1277.4	1308.5	NA
CONSUMER INFLATION, 1980=100	100.0	144.4	178.5	242.8	464.1	639.5	NA
US$/SHILLING, PERIOD AVERAGE	0.16	0.16	0.09	0.06	0.05	0.03	NA
POPULATION, MILL.	4.0	4.2	4.3	4.4	4.5	4.7	NA

MONETARY SURVEY

	80	81	82	83	84	85	86
MONEY SUPPLY, M2, MILL. SHILLINGS	3381.0	4421.0	5116.0	5501.0	6934.0	12558.0	NA
CONSUMER INFLATION, 1980=100	100.0	144.4	178.5	242.8	464.1	639.5	NA
WHOLESALE PRICE INDEX,1980=100	NA	NA	NA	NA	NA	NA	NA
DISCOUNT RATE	4.0	6.0	8.0	8.0	8.0	12.0	NA
COMMERCIAL PRIME RATE	NA	NA	NA	NA	NA	NA	NA
GOVT. BOND YIELD, MEDIUM TERM	NA	NA	NA	NA	NA	NA	NA
DEGREE OF MONETIZATION	NA	NA	NA	NA	NA	NA	NA

SOMALIA

CONSOLIDATED BALANCE SHEET OF
COMMERCIAL BANKS
MILLION SHILLINGS

ASSETS	80	81	82	83	84	85	86
RESERVES	327.0	472.0	465.0	659.0	1048.0	1159.0	NA
FOREIGN ASSETS	339.0	465.0	1428.0	907.0	600.0	4438.0	NA
CLAIMS ON GOVT.	NA	NA	NA	NA	NA	NA	NA
CLAIMS ON PRIVATE SECTOR	426.0	575.0	1624.0	2293.0	3727.0	4025.0	NA
LIABILITIES							
DEMAND DEPOSITS	1181.0	1693.0	2421.0	2790.0	2898.0	5497.0	NA
TIME AND SAVINGS DEPOSITS	595.0	743.0	1078.0	1186.0	1595.0	2778.0	NA
FOREIGN LIABILITIES	0.0	0.0	0.0	0.0	0.0	0.0	NA
GOVT. DEPOSITS	NA	NA	NA	NA	NA	NA	NA
CREDIT FROM CENTRAL BANK	436.0	811.0	1466.0	1825.0	2361.0	2587.0	NA
CAPITAL ACCOUNTS	14.0	14.0	14.0	15.0	15.0	15.0	NA
VALUATION ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
OTHER ITEMS, NET	177.0	-250.0	-355.0	-995.0	-630.0	-630.0	NA

BALANCE SHEET OF CENTRAL BANK

ASSETS	80	81	82	83	84	85	86
FOREIGN ASSETS	158.0	265.0	217.0	278.0	165.0	346.0	NA
CLAIMS ON GOVT.	2440.0	2960.0	3995.0	6055.0	6334.0	7317.0	NA
CLAIMS ON OFFICIAL ENTITIES	240.0	221.0	192.0	201.0	647.0	1446.0	NA
CLAIMS ON COMM. BANKS	413.0	825.0	1424.0	1897.0	2424.0	2522.0	NA
CLAIMS ON SPECIAL BANKS	NA	NA	NA	NA	NA	NA	NA
LIABILITIES							
RESERVE MONEY	1929.0	2452.0	2088.0	2139.0	3456.0	5335.0	NA
OF WHICH							
CURRENCY OUTSIDE BANKS	1508.0	1891.0	1456.0	1355.0	1900.0	3787.0	NA
QUASI-MONEY DEPOSITS	3.0	4.0	5.0	6.0	5.0	7.0	NA
FOREIGN LIABILITIES	352.0	667.0	2164.0	3412.0	5156.0	10263.0	NA
CAPITAL ACCOUNTS	206.0	251.0	175.0	376.0	482.0	751.0	NA
RESCHEDULING ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
VALUATION ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
OTHER ITEMS, NET	222.0	186.0	-499.0	-1752.0	-1484.0	-6622.0	NA

SOMALIA

GOVERNMENT FINANCE
MILLION SHILLINGS

	80	81	82	83	84	85	86
DEFICIT(-)/SURPLUS(+)	NA	NA	NA	NA	NA	NA	NA
REVENUE	NA	NA	NA	NA	NA	NA	NA
EXPENDITURE	NA	NA	NA	NA	NA	NA	NA
FINANCING							
DOMESTIC	NA	NA	NA	NA	NA	NA	NA
FOREIGN	NA	NA	NA	NA	NA	NA	NA

INTERNATIONAL DEBT
MILL. US$

	80	81	82	83	84	85	86
TOTAL EXTERNAL DEBT, (EDT)							
LONG-TERM DEBT	714.1	1026.6	1151.7	1236.2	1277.4	1308.5	NA
PUBLIC AND PUBLICALLY GUARANTEED	714.1	1026.6	1151.7	1236.2	1277.4	1308.5	NA
PRIVATE NONGUARANTEED	0.0	0.0	0.0	0.0	0.0	0.0	NA
USE OF IMF CREDIT	4.3	34.1	67.9	111.5	101.6	142.2	NA
SHORT-TERM	39.0	21.0	33.0	41.0	49.0	35.0	NA
TOTAL LONG-TERM DEBT							
DEBT OUTSTANDING AND DISBURSED	714.1	1026.6	1151.7	1236.2	1277.4	1308.5	NA
DISBURSEMENTS	126.4	376.6	175.5	142.9	109.3	139.5	NA
PRINCIPAL REPAYMENTS	6.9	43.4	10.0	15.5	23.8	40.2	NA
NET FLOWS	119.5	333.2	165.5	127.4	85.5	99.3	NA
INTEREST PAYMENTS	1.9	3.6	9.3	9.5	2.9	17.1	NA
NET TRANSFERS	117.6	329.6	156.2	117.9	82.6	82.2	NA
TOTAL DEBT SERVICE	8.8	47.0	19.3	25.0	26.7	57.3	NA
PRINCIPAL RATIOS							
TOTAL EXTERNAL DEBT							
EDT/XGS)	370.4	423.6	489.0	783.5	1338.3	1164.0	NA
EDT/GNP)	69.7	68.2	72.5	NA	NA	NA	NA
INTERNATIONAL RESERVES	25.8	38.3	15.2	16.4	6.8	8.7	NA

I. THE SUDAN

1. MACROECONOMIC SURVEY

a. Introduction and Discussion of Key Problems

At present, the Sudan is a country in crisis. The symptoms of economic chaos are everywhere. Public revenue covers barely 40 percent of expenditure, imports in value terms are three times greater than exports, inflation is hovering between 30 and 50 percent, the debt service on its US$ 10 billion debt is over 100 percent of export earnings, real wages have eroded to below 20 percent of their equivalent in 1970, the parastatals sector continues to operate at below 40% capacity while operating far in the red, and the banking system has been thrown into disarray by the institution of Islamic Banking in 1984. Furthermore, three years of intense drought and falling world commodity prices, particularly for cotton, have only served to exacerbate the difficulties by constraining agricultural output, Sudan's engine of economic growth.

Whereas policy action has been taken to alleviate these shortcomings, it has proved to be relatively ineffective, inconsistent, and at times, counterproductive.

The Sudan is a country of 21.6 million people. Agriculture is by far the largest employer of the citizenry, accounting for over 80% of total employment. As far as contribution to GDP, agriculture accounts for the largest%age, averaging 30%. Commerce accounts for roughly 23%. Manufacturing contributes a mere 8 percent. Services account for over 12%. TABLE 1 shows a more detailed breakdown of GDP by sector for the years FY1980-84. Given agriculture's large share in GDP and the severe drought in the 1982-84 period, it is not surprising to see a marked decline in real GDP during that period. The poor economic situation during that period was compounded by restrictions on foreign exchange use and credit enforced by the donor mandated structural adjustment program. This severely limited money-lending and trade activities which subsequently constrained growth in commerce, another large sector in the Sudanese economy. TABLE 2 provides a more in-depth look at growth in GDP and its components during the FY1980-84 period.

b. Implications of Key Problems for the Financial Sector

There are several structural problems inherent in the Sudanese economy which directly affect the macroeconomic performance and indirectly the health of the financial sector. They are:

- a very high propensity to consume and thus a very low propensity to save
- an acute balance of payments imbalance
- a fiscal drag on the economy fueled by rising government budget deficits and increasing public debt

284

- high inflation that shows little sign of receding
- regional imbalances

These problems are intensified by an inefficient resource allocation process and an underdeveloped financial sector thwarted by government over regulation. Without structural reform there is little hope of improved economic performance and thus financial sector development in the foreseeable future.

2. FINANCIAL SECTOR

a. Institutions

The financial system in the Sudan is similar to that in many other mixed-economy developing countries. It comprises a Central Bank, state-owned commercial banks, privately owned commercial banks, and several specialized banks. The Central Bank is the Bank of Sudan which was established in 1960. There are five state-owned commercial banks:

Bank of Khartoum
Nilein Bank
Unity Bank
Sudanese Commercial Bank
National Export-Import Bank

Excluding the Export-Import Bank which was established in 1983 to provide trade financing, all these commercial banks were privately owned prior to being nationalized in 1970.

Presently there are 15 privately owned commercial banks. These can be sub divided as follows. Six are foreign owned:

Bank of Credit and Commerce International
Abu Dhabi Bank
CitiBank
Habib Bank
Bank of Oman
Middle East Bank

Nine are joint venture banks. Five of these nine are Islamic Banks:

Faisal Islamic Bank
Tadamon Islamic Bank
Sudanese Islamic Bank
El-Baraka Islamic Bank
Islam Bank for Western Sudan

The other banks are:

Sudanese International Bank
Sudanese National Islamic Bank
National Bank for Development
Blue Nile Bank

285

All of the above-mentioned fall under the jurisdiction of the Central Bank. In addition, there are four specialized banks which are not under the control of the Central Bank:

Real Estate Bank
Industrial Bank of Sudan
Agricultural Bank of Sudan
Sudanese Savings Bank - [the only local bank with its headquarters outside Khartoum (in Wad Medani)].

There are also two other institutions which perform banking activities but are not supervised by the Central Bank:

Islamic Cooperation Bank for Development - [owned by the Ministry of Finance, the Ministry of Commerce and the Cooperatives Movement]

Sudanese Development Corporation - [a quasi-investment bank under the control of the Ministry of Finance]

These banks were established to fulfill a special need which is to direct a%age of their credit allocation to specific sectors and geographic areas of the economy rather than perform commercial banking functions.

b. Central Bank

The Central Bank was established to license and regulate the commercial banks, control monetary and credit policies, and oversee all foreign exchange transactions. However, its competence in performing these duties has at times left much to be desired. In the last several years, the principal tools used by the Central Bank to control the monetary sector have been credit ceilings and exchange rate devaluations. It was the large amount of liquidity and excess credit in the commercial banks that was not under the control of the government that led to the formation of the Central Bank in 1960 and later led to the nationalization of the commercial banks in 1970. Since that time the Central Bank has primarily used credit ceilings to control commercial bank lending and borrowing activities.

Concerning its foreign exchange intervention, although in recent years its devaluation policy has been relatively effective in reducing the serious overvaluation of the Sudanese pound, it has failed to close the large gap between the official and black market rates. Thus a large portion of formal market transactions and nearly all remittances from Sudanese citizens living abroad pass through the informal exchange rate market and elude control by the Central Bank. This definitely limits the Central Bank's ability to control foreign exchange transactions and injects instability into the official and commercial rates.

The Central Bank has also been rather negligent in regulating the activities of the commercial banks. Although the Bank of Sudan determines credit ceilings and credit allocations, it has

286

become evident that a large number of commercial banks either disregarded or circumvented those regulations. The specialized banks have been performing commercial banking activities, while the commercial banks have been restricting their lending to short-term commercial transactions rather than following the credit allocation restrictions mandated by the Central Bank. However, recent investigative committees set up by the Central Bank have begun to highlight illegal activities by the commercial banks and tougher regulations in the near future are expected.

In light of the above-mentioned problems, there are serious questions of credibility of the Central Bank. Past policy actions have been ineffective, untimely, and inconsistent. Regulations have been bypassed and ignored, and the informal market for both credit and foreign exchange has flourished.

c. Commercial Banks

To discuss the activities of the commercial banks it is convenient to divide them into sub groups along the lines of ownership. The first group is state-owned commercial banks including Bank of Khartoum, Nilein Bank, Unity Bank, Sudanese Commercial Bank, and the National Export-Import Bank. In 1979, these banks controlled 86.5% of all deposits and thus effectively controlled the domestic market. By 1985 their control of deposits had fallen to 58.7% as additional banks provided competition. Their share of trade financing also was reduced significantly. This is despite the fact that the state-owned banks enjoy preferential treatment from the Central Bank. This preference is manifested in:

-- higher credit ceiling on non-national banks to finance development even though the long-term nature and inherent risk make this the least profitable type lending.

-- the capitalizations requirements of non-national banks are significantly higher, US$10 million for non-national compared with roughly US$5 million for state-owned.

-- high tax rates on banks also has a detrimental impact on non-national banks since the state-owned banks turn their profits over to the government anyway.

-- restrictions on deposit acceptance by non-national banks.

Despite all these biases against the non-national and in favor of the state-owned commercial banks, the non-national banks are controlling a larger share of the market than before. This stems from the fact that the state-owned commercial banks are suffering from a lack of quality service and are relatively inefficient. Lack of innovation is also a problem for the state-owned banks since management is in effect the Bank of Sudan and in some cases the Ministry of Finance. Thus there is little competitive strategy and creative management among the state-owned banks themselves.

287

The second group of commercial banks is the foreign owned commercial banks. These include the Bank of Credit and Commerce International, Abu Dhabi Bank, CitiBank, Habib Bank, Bank of Oman, and Middle East Bank. These banks were permitted to operate in the Sudan following a policy directive in 1974 to stimulate foreign investment in Sudan's development. In general, these banks were expected to provide funds for development and medium-to long-term financing. However, TABLE 3 makes it evident that these banks are not concentrating in the areas that the government had anticipated. Rather than providing funds for medium- to long-term investments, these banks have funnelled the majority of their funds into short-term commercial and trade financing which is much more profitable and less risky. In the 1977-85 period, the foreign banks directed only 2.6% of their total lending the prescribed areas. This is counter to the government credit allocation directive requiring 20% to 35% of total annual lending (depending on type of bank) to be directed to medium- to long-term borrowers. As mentioned previously, recent government investigations have begun to highlight many of these banking irregularities concerning credit allocations and ceilings and tighter compliance is anticipated.

The third group of commercial banks is the joint venture banks. This group includes the five Islamic banks; Faisal Islamic Bank, Tadamon Islamic Bank, Sudanese Islamic Bank, El-Baraka Islamic Bank, and the Islam Bank for Western Sudan, as well as the four other commercial banks; Sudanese International Bank, Sudanese National Islamic Bank, National Bank for Development, and the Blue Nile Bank. These banks are also licensed under the assumption that they will concentrate their lending to medium- to long-term investments. However, as was the case with the foreign owned banks this is not occurring. In the 1977-85 period, these joint venture banks concentrated only 5% to 14% of their total lending to financing medium- to long-term projects. They are also the focus of the government banking irregularities investigations.

The domestic banks not under control of the Central Bank are the fourth group of banks in the Sudan. They include the Sudan Development Corporation, the Islamic Cooperation Bank for Development, and the Savings Bank. These banks are either directly or indirectly under the control of the Ministry of Finance and were established to fill a special need within the financial system. This responsibility has not been fulfilled. The Islamic Cooperation Bank was originally established to provide working capital to the cooperatives; however, it has assumed normal banking activities with the brunt of its lending to finance short-term commercial activities.

The Savings Bank, with its headquarters in Wad-Medani, was established in 1976 by the Bank of Sudan to access small savers in the rural areas and channel those funds back into small-scale rural artisan projects. However, the bank, with over LS.80 million in deposits, has disregarded its original focus by concentrating 36.4% of its lending in commerce, 25.9% in

288

agriculture, and 20.4% in transportation. Only what is left is being channeled back into small-scale rural artisan projects.

The Sudan Development Corporation is the only one of these banks which is actually maintaining its focus, the majority of its lending being for medium- to long-term development projects. However, it is constrained by a lack of capital. As of late, in fact, it has begun to assume other banking responsibilities, particularly short-term commercial financing as the number of development projects it is able to finance falls and the rewards for short-term financing increase.

The final group of banks in the Sudan is the specialized banks. They were established in the 1960s to finance productive capacity in the industrial and agricultural sector. All three of the banks, the Industrial Bank, the Agricultural Bank, and the Real Estate Bank, were originally capitalized at less than LS.7 million but those have since been raised to LS.18.7 million, LS.50 million and LS.15 million, respectively, by 1985. The rather low capitalization is important given that these banks do not accept deposits. This seriously affects their ability to finance medium- to long-term development projects. Furthermore, from TABLE 4 we can see that the majority of their lending is in relatively developed areas where they can maximize their return while minimizing both the risk and the lending period. Political cronyism and pork-barreling are also influencing factors. This regional imbalance is a severe constraint on the overall development of the financial sector. It also is inhibiting economic development and the quality of life in the rural areas.

In general, regional imbalance is a key issue throughout the Sudanese banking sector. As of May 1986, there were 174 bank branches in the Sudan. Of that nearly 40% are located in Khartoum, 18% in the Eastern Region, 16% in the Central Region, 9 percent in the Kordofan Region, 6% in the Northern Region, and the remaining 11% are scattered among the Southern Region and the Darfur. The fact that the capital and the two other regions account for 84% of the total branch locations, however, still conceals the bias since the majority of the rural branches do not have authority to extend credit. Thus, although rural branches exist they are not in effect banking facilities but rather representatives of the Khartoum-based bank. Informed sources estimate that actual lending in remote areas averages roughly 10 percent of deposits in the branches compared to 150% in Khartoum. Thus a large majority of rural credit needs are ignored or refused. Rural citizens are then forced to tap the informal financial markets. This further compounds the Central Banks money supply control problems. It also reduces the demand for innovative financing in the official market which subsequently affects overall financial market development.

d. <u>The Informal Financial Sector</u>

In light of the above-mentioned regional imbalance and the difficulty of the rural farmers in securing institutional credit,

289

there exists a very large informal credit market in the Sudan called the "Sheil System". It is estimated that nearly 90% of all agricultural credit is supplied by this informal system. It is fueled not only by surplus units in the agricultural sector but also by overseas Sudanese remittances. The moneylender earns his return either by charging interest or by serving as a marketing outlet for the farmers, selling off the harvest. Either way, the cost or interest is positive in real terms and adequately compensates the moneylender for the risk. Otherwise the system would not be growing at the magnitude that it is today. While disarray continues to plague the formal financial sector, the informal sector will continue to expand.

The informal sector also operates parallel to the formal financial sector in foreign exchange transactions. Tight foreign exchange regulations after the first structural adjustment program and Sudan's high propensity to consume, particularly in this case, imports, provided the demand to propel this thin market into high growth. At times during the 1980-85 period, the strength of demand pushed the black market exchange rate nearly three times the official rate. Failure on the Central Bank's part to maintain an equilibrium official rate through timely devaluations only serves to prime the pump of this informal sector. Unless the Bank of Sudan can begin to reduce its over-regulation of the foreign exchange market and push to unify the exchange rate regime, there is little hope of displacing or controlling the informal market either for credit or for foreign exchange. At the same time, there are some basic problems associated with heavy dependence on the informal sector:

(1) The informal market is controlled by small-scale moneylenders. This leads to market segmentation and arbitrary lending. Economies of scale and operational efficiency are difficult if not impossible to attain.

(2) The lack of knowledge of the informal sector increases the uncertainty of success of a particular policy action.

At present the informal market has a positive role in the economy. In addition, there is no guarantee that liberalization will give the formal financial sector the incentive to respond to the needs now served by the informal market. Furthermore, there is no proof that geographic biases are derived from formal market regulation. Therefore, the informal market in the Sudan must be studied more intensively.

e. Islamic Banking

Prior to 1984 both Islamic and traditional banks operated side-by-side. However, following a court ruling in 1984 all banks in the Sudan were required to operate under Islamic Banking Law. That is banking without interest. Rather than pay interest on deposits, the Islamic banks provide a rate of return dependent on the profit/loss of the bank. Deposits are not guaranteed. If the depositor wishes the deposits to be guaranteed, then the bank

240

pays no return. As for lending, there are generally three types; the Murabaha, the Musharaka, and the Mudaraba.

The Murabaha method is the most widely used method of Islamic banking. In this case the bank provides the capital to purchase a commodity at the request of the lendee. The bank then sells the commodity to the lendee at a marked-up price. This mark up is supposed to be suggested by the borrower but in practice this premium is set by the bank before the transaction is consummated. 2% per month (24% annually) is the average profit rate.

The second method of Islamic banking is the Musharaka method. In this case the bank and the borrower act as joint venture partners. Here, the borrower, providing 20% to 40% of the capital himself, and the bank purchase a commodity which they later sell. The profits from the transaction are distributed to each partner with the majority going to the bank. This is the closet similarity to investment banking in the Islamic system although the majority of these transactions are trade related.

The third method of Islamic banking, the Mudaraba method, is seldom used. In this case the bank provides the capital and any profit that the borrower earns is divided between the bank and the borrower. However, if the borrower loses the money, then the bank is singularly responsible. Obviously this method is seldom used by the Islamic banks because of the undue risk that is inherent.

In general, the introduction of Islamic banking in the Sudan was a shock to the system. It appears that little change in banking practices has actually occurred. Where before there was an interest cost, now there is a transaction cost. Furthermore, despite their theoretical desire to serve the development process, the Islamic banks have concentrated their business in the same areas that they were concentrated in before; short-term commercial lending. The change over to Islamic banking did provide an unwelcome upheaval in the marketplace, however. In addition, two rather troublesome side-effects of this lending focus have materialized, namely:

(1) the cost of capital to industry has accelerated rapidly, nearing 43% as the banks force medium- to long-term borrowers to pay dearly. This is little aid to an economy in crisis or to the parastatals that are bending under the debt burden.

(2) the elimination of interest on saving banks deposits, Since no alternative has been proposed, large clients are threatening to remove their savings. This would have serious ramifications for the Savings Banks' future viability.

Despite these problems and given the relative regional imbalance in the banking system and the small niche in the rural areas that these small banks serve, the loss of their service

291

would be contrary to any policy which wishes to develop and expand rural resource mobilization. However, their lending policies do need to be re examined. The regional imbalance will be exacerbated if the Islamic banks continue to mobilize their lending in the capital at the expense of the rural areas.

In addition, further study of the economic and policy implications of Islamic Banking must be examined. Banking without interest critically limits the Central Bank's monetary policy tool options. If interest rates cannot be used to control credit supply and demand then the only real tools left are reserve requirements and credit controls. Both are only marginally effective, particularly during periods of slow economic growth when bank liquidity is high and demand for funds low. Clearly, a more comprehensive look at Islamic Banking and its place in and effect on economic policy is imperative.

f. Financial Sector Regulation

The regulatory environment in the Sudan is not conducive to financial market development. It forces the banking community to operate within a very narrow field of services. Decisions are not made on rate of return but on Central Bank directive. Innovation in financing is thwarted. Competition is weak. Unless deregulation accompanies any financial sector reform policies, success will be limited.

Prior to 1980 the Central Bank used reserve requirements and credit ceilings as the main tools to control the liquidity in the financial system. However, the credit ceilings were so restrictive that banks found that short-term lending was more profitable than lending in the medium to long term. In addition, import and foreign exchange restriction reduced the demand for trade financing. Liquidity in the commercial banks increased accordingly and the reserve requirements became a moot point.

The main tools used by the Central Bank today are credit controls and foreign exchange restriction. The most recent Central Bank regulations, released November 1986 are as follows;

(1) 30% of each bank's credit ceiling to finance exports

(2) 25% to finance working capital for industry

(3) 20% to finance medium- to long-term development for state-owned banks, 35% for private banks

(4) foreign banks cannot finance trade

(5) joint venture banks can only finance trade using the Murabaha (cost plus financing) method or the Musharaka (participation) method. The regulations also require that banks increase their capital to 20% of deposits from 12.5%. However, this is unnecessary given that reserves are estimated at over 25% of deposits.

292

The policy objectives underlying these regulations can be summarized as follows:

- Export promotion to ease the balance of payments crisis
- Industrial growth to provide import substitution and diversify the economy
- Encouraging the private sector to be key in the development process
- Redirecting the profits from trade financing toward the domestic banks instead of allowing them to be repatriated.

Although these policy objectives are praiseworthy in direction, there are not sufficient incentives within the economy for them to be effective. Furthermore, there is inadequate policy regulation to attain the goals and there is increasing doubt about the governments sincerity to actually attain the goals.

- Foreign trade will continue to be constrained by productive capacity in the export sector.
- Strong industrial growth is not possible until the high costs of capital, production, and scarcities can be reflected in the price of the output. This is also the main factor for the lack of private sector development. The costs are too high and the return is too low to compensate for the risk that must be borne by the private investor.
- Allowing only domestic banks to finance lucrative trade transactions only concentrates the wealth in the hands of the least efficient and effective banking sub sector.

Therefore, as in the past, Central Bank credit regulations appear unsustainable in the context of the macroeconomic conditions. Furthermore they inhibit sound financial market development. Central Bank credit policy reform should be a high priority in donor administered restructuring programs.

The Central Bank's foreign exchange restrictions are also driven by misdirected policy. The latest Central Bank directive issued November 1986, states that all foreign exchange will be pooled by the Central Bank. Import licenses will be issued by a committee of banking and government officials. The idea of this restriction is to limit private imports and free up foreign exchange for state owned enterprises. Once again this is a policy action removed from the reality of the context since:

(1) the potential for political cronyism and pork-barrelling is immense. Foreign exchange use will be granted on an arbitrary basis rather than on the return that foreign exchange could earn.

243

(2) the parastatals that will have priority over the foreign exchange are inefficient, mismanaged and debt ridden and should be concentrating on domestic sourcing rather than on expensive imports. Furthermore, this is directly contrary to the government's stated intention of providing incentives for private sector development.

(3) the government's attempts to limit private imports will only increase demand for both foreign exchange and imported goods in the informal market. Subsequently a large devaluation of the Sudanese pound in the black market could be expected. This will further pressure the official and commercial rates and undermine the Central Banks desire to arrest the recent sharp depreciations of the Sudanese pound and to unify the official and free rates.

In light of the above-mentioned problems, it is imperative that the Central Bank with donor community support re examine its policies and the context in which they must operate. Until the Central Bank can provide the necessary leadership and direction, financial market development will be elusive.

3. GOVERNMENT POLICIES AND THEIR IMPLICATIONS FOR THE FINANCIAL SECTOR

a. Monetary Policy

Under the government's monetary policy, efforts to control inflation have only been marginally effective. Its mounting budget deficit combined with large parastatal operating losses were in part financed through money creation. In the absence of any significant growth in GDP during the FY1980-85 period, this monetization of the debt only served to further fuel inflation, which averaged over 32% during the period. In addition, increasing commodity aid which allowed the government to follow an expansionary policy by spending the counterpart funds, also had a detrimental impact on monetary growth. TABLE 5 shows money supply growth compared with inflation during the FY1980-85 period. Clearly there is a strong lagged correlation between the government's failure to pursue a sustainable monetary policy and inflationary pressure on the economy.

Meanwhile the government debt management has also been a failure. Sudan has now been through two debt reschedulings but arrears continue to mount. The debt service on its US$40 billion is over 100% of export earnings. Given that export earnings are expanding at a very slow pace, no debt relief save donor support appears in the near future. Even with donor aid, the debt picture will not improve significantly before 1995, assuming (questionably) strong economic growth over the next eight years.

Thus the government's monetary policy has in fact been counterproductive to financial market development. It has fueled inflation which has escalated the required return to capital on any given project so exorbitantly high that little or no

244

long-term economic development can be undertaken at a profit. It has increased the demand for funds outside the formal sector which further complicates the Central Bank's policy strategy. Third, it has exacerbated the economic difficulties of the economy by increasing external debt to unsustainable levels. Finally, it has created a disincentive for consumer savings and forced mobilized resources into high return, speculative purchases such as gold and real estate rather than into the banking system. Until the government adopts a sustainable monetary position in line with economic conditions financial market development will proceed at best lethargically.

b. Fiscal Policy

Declining central government revenue and increasing expenditures in the early 1980s led to large budget deficits, nearing 15% of GDP, and increased Central Bank borrowing. Under the first structural adjustment program in 1982 expenditure was slashed dramatically and the deficit stabilized at around 7% of GDP. A closer inspection, however, shows a disturbing picture.

- revenues stagnated
- recurrent expenditure declined
- development expenditure fell
- a sharp increase in non budget expenditure
- reduction in Central Bank lending
- increased use of foreign aid and foreign debt to cover current expenditure
- increase reliance on debt rescheduling

Thus the government did little to actually reduce its budget deficit and free up domestic resources for productive use. In fact it relied on the international donor community to support its fiscal policy. Foreign aid combined with rescheduled debt nearly equalled total revenue from domestic sources in FY1983. Unfortunately, since 1982, the situation has not improved. The introduction of the Zakat tax system in 1984, part of the islamization of the economic system, effectively eliminated income taxes. As a result, the budget position has further deteriorated. An increase in excise and trade taxes countered some of this reduction in receipts, but not significantly. Meanwhile actual expenditure has fallen only slightly. This is not a sustainable policy course.

Nor is it a sustainable course in terms of financial market development. The government's bias in favor of consumption at the expense of productive investment in effect reduces the potential funds available for allocation by the commercial banks. It also reduces the demand for banking services and support.

295

Thus an opportunity for financial market development is lost. The government's credit allocation to the parastatals also hinders financial market development. Funds are diverted to these industries regardless of return or performance. Thus there is no economic decisionmaking based on creditworthiness or return. This leads to complacency and pork-barreling rather than competitive aggression among banks.

Without a more responsible fiscal management attitude, the Sudan's economic problems will only intensify. A coherent, consistent fiscal policy is a prerequisite for economic stabilization and subsequently for financial development. The stabilization policy must provide a sound foundation for economic development before any success in financial market development can be achieved. Without exceptional resource mobility there is little hope of breaking the vicious cycle of Sudan's economic crisis.

c. Structural Adjustment Programs

The first structural adjustment program in the Sudan, instituted by the IMF in 1978, came about because of a severe balance of payments disequilibrium. The major components of the program included: (1) price structure adjustments, (2) strict demand management, (3) institutional reforms particularly of the parastatals, and (4) stimulation of the private sector and market forces. The focus of the program was foreign exchange and price measures augmented by strict demand control.

Contrary to the 1975-80 period in which Sudan experienced positive real growth averaging 4.5%, in the 1980-85 period, under the donor suggested stabilization program, the country averaged real growth of negative 1.5%. Several factors heavily influenced this economic slide. The first was the three-year drought during the 1982-85 period which seriously curtailed agricultural growth. Industrial growth also contracted during the period as raw materials, electric power, spare parts, and qualified personnel were in short supply. A continually overvalued exchange rate also hastened the economic slowdown as the export sector faced an uncompetitive pricing system while imports flourished. This forced the government to divert its precious foreign exchange to filling the resource gap rather than toward productive investment. Also during this period, government receipts recorded negative growth while expenditure remained basically constant. Thus the mounting budget deficit, financed both domestically and internationally, led to a swiftly rising money supply, high inflation, and rising foreign debt. This derailed the stabilization program in late 1984.

Donor-mandated studies of the problems and failures of the program cited several factors which were not adequately addressed during the reform process.

- The increased use of devaluations of the Sudanese pound to correct for an historically overvalued currency was

296

implemented sporadically and without a clearcut strategy.

- Control of the budget deficit, key to the success of any devaluation package, was generally disregarded.

- Policy delays in implementing the devaluations gave economic incentives to the production and consumption of non tradable domestic goods and imports at the expense of tradable and export-oriented goods.

- Although the government publicly stated its intent to sell off unprofitable parastatals and combine others to achieve economies of scale, it did nothing to reduce the debt burden that this sector imposes on the economy.

- The government's rigid price control system continued to misinform both the producers and consumers of the economic scarcities.

- The islamization of the banking and tax systems also proved to be a questionable policy. Given the poor economic performance and a general lack of confidence in economic stability, a policy which throws the entire financial community into disarray while providing little or no benefit, clearly does more harm than good.

It was not until mid-1985 that a new economic policy proposal by the government (PPED - III) met with popular donor support and a new short-term stabilization program was arranged. The present donor reform program, the "Economic Salvation Programme" has been adopted to save the economy from falling into an economic abyss. In general, the latest reform program incorporates many of the goals of the former program. However, it attacks the problems more specifically and aggressively. The objectives of the program in the 1986/87 - 1987/88 fiscal year are :

- real GDP growth above 7%

- reduce inflation to near 20%

- increase production in agriculture and industry while promoting exports

- increase productive capacity

- curtail consumption

- reduce budget deficit by increasing revenue and reducing unnecessary expenditure

- reduce imports for consumption

- medium-term growth

Although it is still too early in the reform process to see tangible results, it appears evident that the goals of the program will not be met. Government revenue collections remain weak and efforts to compress private consumption are meeting with resistance. One positive note, though, is rising petroleum prices. This will undoubtedly aid the balance of payments and budget deficits. If this increased revenue can be channeled to productive investment, the medium- to long-term economic picture will improve. The additional flow of funds will also promote accelerated development and deepening of the financial sector.

USAID has also met with only marginal results in its aid programs, the majority focusing on agricultural production and marketing. The primary reasons for the only limited success appear to be poor project design and management by USAID and lack of support by the government of Sudan. The goals for the programs also exaggerated the possibilities. Development must proceed at a slow but steady pace in a country were the economic situation is so poor.

4. CONCLUSIONS AND RECOMMENDATIONS

Conclusions:

(1) The financial sector's disarray reflects the condition of the economy: a significant regional imbalance, inefficient resource allocation, an unproductive public sector, and an inconsistent and unsustainable development strategy. Therefore there is no prospect for financial market reform until there is economic stabilization.

(2) The government's attitude toward financial sector reform is symptomatic of its general attitude toward stabilization/structural reform. Namely, it pays lip service to stabilization goals and promotion of the private sector but lacks the will to implement financial reform. Therefor, no reform package will be effective until the government not only adopts a pro reform attitude but is politically capable of surviving the structural adjustment period.

(3) The present failure of the formal financial sector is in part compensated for by the relative success of the informal financial sector to meet the needs of rural areas. The informal sector, however, has many short comings; it is not an optimal allocator of resources, it fosters market segmentation, and it is believed to entail substantial costs to the borrower. However, as long as the formal sector continues to concentrate on short-term trade financing, rural borrowers will be willing to accept the inefficiencies of the informal market in order to gain access to funds. Similarly, as long as foreign exchange restrictions remain in force and the gap between the official and the black market exchange rates remain large, importers will continue to access funds through

92

the informal market as well. In light of the need which it serves, the question, then, is not how to eliminate the black market but rather how to manipulate it into achieving the policy goals of economic and financial market development without alienating segments of the population in the process.

(4) While the introduction of Islamic Banking has created problems, it should not be a hindrance to efficient resource mobilization and allocation. Islamic Banking will be a fact of life in the Sudan, given its access to certain segments of the population. It can be made to play a positive role in development if properly directed.

Recommendations:

(1) Areas that require drastic reform:

(A) Central Bank - Credibility needs to be enhanced through increased commercial bank monitoring, particularly in the area of credit allocation. The Central Bank also needs an improved strategy of exchange rate adjustment which would narrow the gap betweeen the official and black market rate so as to reduce the incentive to bypass the formal sector.

(B) Overall structure of the commercial banking sector - Overbanking is a serious problem in the Sudan. There are an excessive number of uncompetitive banks with only marginal performance and a very small pool of funds. Troubled and illiquid banks should be privatized, liquidated, or absorbed by other more profitable banks.

(C) Regulation - More liberalization is needed especially in the area of credit allocation. The greatest example of the failure of the banking system is that credit ceilings have led to high liquidity . Thus banks are not accepting deposits at a time when financing needs of the economy are inadequately satisfied or satisfied through the informal market.

(2) Although reforms are needed, the current climate is not conducive to successful reform of the financial sector. Therefore it is recommended that progress be made toward stabilization before these reforms can be implemented. Specifically, a unified foreign exchange rate is a sine qua non of financial sector reform.

(3) In the reorganization of the banking system, the state banks should be treated like other parastatals. Those not viable should be eliminated by absorption by the private sector. Those that are seen to play a positive role should be restructured with a view to improving financial performance.

(4) There is scope for further study of a number of financial sector related areas which can be undertaken while awaiting the opportunity to proceed along the path of financial sector reform. The key areas are:

- The informal sector - size, scope, function, key inefficiencies

- Islamic banking - underlying theory, its prospects of achieving operational efficiency, role and activity in development.

(5) The Central Bank would greatly benefit from technical assistance to improve monitoring standards. Technical assistance should also be provided by pilot training programs that can be used more widely throughout the entire banking system.

(6) The Sudan Development Corporation should be given a credit facility. It is one of the few institutions to perform well given its purpose. However, it is constrained by low capitalization.

300

BIBLIOGRAPHY

Abdalla, Ali "Economic Policy and Islamization of the Banking System in Sudan", University of Khartoum (Khartoum: 1985).

Ahmed, A. Hu. "Agricultural Finance in the Sudan", Manuscript (Khartoum: 1984).

Bank of Sudan, "Bank of Sudan Twenty-Sixth Annual Report - 1985", Bank of Sudan (Khartoum: 1985).

Bank of Sudan, "Economic and Financial Statistics Review, July - Sept. 1986", Bank of Sudan (Khartoum: 1986).

Bank of Sudan, "Foreign Trade Statistics Digest, April - June 1986", Ban Sudan (Khartoum: 1986).

Beshai, Adel Amin, "Export Performance and Economic Development in Sudan, 1900-1967", Ithaca Press for the Middle East Centre, St. Antony's College, 358 pp. (London: 1976)

Bhargava, R.N. and Haggstrom, G.M., "Report of the Mission to Evaluate Small Hydro-power Sites in Sudan, 27 November - 15 December, 1981", U.N. Dept. of Technical Cooperation for Development, 78 pp. (New York, N.Y.: 1981)

The Democrat, "Economic Salvation Programme: the Short Term Measures, FY1986/87", Manuscript (Khartoum: 1986).

The Democrat, "Prospects, Programmes, and Policies for Economic Development - III, 1984/85, Manuscript (Khartoum: 1985).

Development ... "Sudan Banking System: Cracks in the Wall", Development ... (Khartoum: 1986).

Hamdi, Abdul, "Evaluation of Islamic Banking in the Sudan", Manuscript (London: 1986).

IBRD, "Sudan: Pricing Policies and Structural Balances", IBRD (Washington, D.C.:1985).

IBRD, "Sudan: Prospects for Rehabilitation of the Sudanese economy - Vol Manuscript (Washington, D.C.: 1985).

IBRD, "Sudan: Prospects for Rehabilitation of the Sudanese economy - Vol II", Manuscript (Washington, D.C.: 1985).

IBRD, "Sudan: Prospects for Rehabilitation of the Sudanese economy - Vol III", Manuscript (Washington, D.C.: 1985).

IBRD, "Sudan: Public Enterprise and Economic Management Project Paper", Manuscript (Washington: 1987).

International Disaster Institute, London, "Strengthening Disaster Preparedness in Six African Countries", Ford Foundation

(Sponsor), 111 pp. (New York, N.Y.: 1985)

Jucker-Fleetwood, Erin Elver, "Money and Finance in Africa; the Experience of Ghana, Morocco, Nigeria, the Rhodesia and Nyasaland, the Sudan, and Tunisia from the Establishment of their Central Banks Until 1962", G. Allen Unwin, 335 pp. (London: 1964)

Kubinski, Z.M., "Public Finance for Stability and Growth in an Underdeveloped Export Exonomy; a Case Study of the Republic of Sudan", International Bureau of Fiscal Documentation, Amsterdam (1961)

Meagher, Robert F., "Public International Financing in Sudan", Columbia University School of Law, New York, N.Y. (1965)

Nelson, Harold D., "Sudan: A Country Study", American University, Foreign Area Studies, U.S. Government Printing Office, 365 pp. (Washington, D.C.: 1982)

Shaaeldin, E. "Towards an Understanding of Islamic Banking in Sudan", University of Khartoum (Khartoum, 1985).

Smith, Hadle. "Private Enterprise Development in Sudan", Manuscript (Khartoum: 1984).

Umbadda, Sidd., "The Working of the Banking System in Sudan", Manuscript (Khartoum: 1986).

302

TABLE 1

GROSS DOMESTIC PRODUCT AT FACTOR COST AT CONSTANT 1981-82 PRICES (LS. MILLIONS)

SECTOR	1980-81	1981-82	1982-83	1983-84	1984-85
Agriculture	2133	2062	1785	1697	1583
Commerce	1314	1349	1350	1330	1320
Manufacturing & Mining	456	470	482	499	519
Transport & Communication	587	647	580	565	572
Construction	260	280	300	320	312
Electricity & Water	111	117	123	129	132
Government Services	619	610	620	617	643
Other Services	510	528	545	573	552
G.D.P.	5990	6063	5785	5730	5633
Change in GDP	+4.6	+1.2	−4.6	−1	−1.7
Price Index	83	100	130	157	185

SOURCE: —

Ministry of Finance and Economic Planning (Planning), Prospects Programmes and Policies for Economic Development - III 1984-1985 - 1986-87.

TABLE 2

ESTIMATES OF GROSS DOMESTIC PRODUCT AT CURRENT PRODUCER'S PRICES BY ECONOMIC ACTIVITY (IN LS. MILLIONS)

	1980-81		1981-82		1982-83		1983-84		1984-85	
	Value	% Share	Value	% Share	Value	% Share	Value	% Share	Value	% Share
Agriculture	1770	35.6	2062	34.0	2320	30.8	2664	29.6	2929	28.2
Commerce	1091	22.0	1349	22.2	1755	23.4	2088	23.2	2442	23.4
Manufacturing and Mining	378	7.6	470	7.8	627	8.4	783	8.7	0960	09.2
Transport and Communication	487	9.8	647	10.7	754	10.0	887	9.9	1038	10.1
Construction	216	4.3	280	4.6	390	5.2	502	5.6	0577	05.5
Electricity and Water	92	1.9	117	1.9	160	2.1	203	2.2	0244	02.3
Government Services	514	10.3	610	10.1	806	10.7	969	10.8	1190	11.5
Other Services	424	8.5	528	8.7	709	9.4	900	10.0	1021	09.8
GDP at Current Producers Prices	4972	100	6063	100.0	7521	100	8996	100	10421	100

SOURCE.- See Table 2-1

Source: Bank of Sudan

TABLE 3

SELECTED BANKS' HIGHLIGHTS, 1983-84

(Banks' financial years)

SUDAN

	Total assets		Capital & reserves		Net profits	
	1983	1984	1983	1984	1983	1984
Bank of Khartoum	na	5,718.6	na	22.6	na	na
Islamic Bank for Western Sudan[x]	-	915.0[+]	-	na	-	na
El-Nilein Bank	409.6	462.5	13.6	18.4	24.2	29.0
Faisal Islamic Bank (Sudan)	441.3	447.3	129.1	132.8	9.4	9.6
Sudan Commercial Bank	175.8	198.0	5.0	5.0	1.5	2.4
AlBaraka Bank of Sudan[xx]	-	143.9	-	55.2	-	na
Tadamon Islamic Bank of Sudan	57.4	80.3	na	na	na	1.0
Blue Nile Bank[++]	20.1	61.3	10.0	12.0	-0.1	1.1

na = not available

x Set up August 1984

\+ May 1985

xx Set up March 1984

++ Set up October 1983.

Exchange rate: $1 = LSud 1.30.

Source: Bank of Sudan

TABLE 4

Regional Distribution of Specialized Banks Credit

	AGR.BNK (1985)		INDUS.BNK (1984)		ESTATE BNK(1985)	
	AMOUNT LS'000	%	AMOUNT LS'000	%	AMOUNT LS'000	%
Khartoum	1.52	2.2%	6.64	85.2%	0.29	63.91
Central Region	23.79	35.5%	0.78	1%	0.02	3.3
Northern "	6.29	9.38	0.54	0.7%	0.04	9
Eastern "	15.32	22.9%	1.02	13.1%	0.43	9.5
Kordofan "	10.33	15.4	-	-	0.05	11.4
Darfur	0.73	1.1	-	-	0.003	0.7
Southern	9.04	13.5	-	-	.01	3.2
TOTAL	67.02	100%	7.79	100%	0.453	100%

Source: Economic Survey 1985/86

Ministry of Finance and Economic Planning

THE WEFA GROUP

SUDAN

OCT 13, 1987

MACROECONOMIC VARIABLES

	80	81	82	83	84	85	86
GROSS NATIONAL PRODUCT, MILL US$	6958.3	8577.8	7994.7	7364.8	7217.9	7924.8	NA
GNP PER CAPITA, US$	372.1	446.7	403.8	361.0	343.7	366.9	NA
EXPORTS, FOB, MILL US$	542.7	656.8	498.1	623.5	628.7	373.9	NA
CURRENT ACCT. BAL., MILL US$	-320.2	-639.9	-248.3	-219.5	25.4	151.7	NA
TOTAL EXTERNAL DEBT, MILL US$	3801.8	4540.9	5116.9	5684.2	5663.0	5086.0	NA
CONSUMER INFLATION, 1980=100	100.0	124.6	156.6	204.5	274.3	398.8	NA
US$/POUND, PERIOD AVERAGE	2.00	1.87	1.07	0.77	0.77	0.44	0.40
POPULATION, MILL.	18.7	19.2	19.8	20.4	21.0	21.6	NA

MONETARY SURVEY

	80	81	82	83	84	85	86
MONEY SUPPLY, M2, MILL. POUNDS	1264.2	1795.0	2534.1	3110.4	3718.9	6108.1	7755.8
CONSUMER INFLATION, 1980=100	100.0	124.6	156.6	204.5	274.3	398.8	NA
WHOLESALE PRICE INDEX,1980=100	NA	NA	NA	NA	NA	NA	NA
DISCOUNT RATE	NA	NA	NA	NA	NA	NA	NA
COMMERCIAL PRIME RATE	NA	NA	NA	NA	NA	NA	NA
GOVT. BOND YIELD, MEDIUM TERM	NA	NA	NA	NA	NA	NA	NA
DEGREE OF MONETIZATION	0.3	0.4	0.4	0.3	0.4	0.3	NA

35

SUDAN

CONSOLIDATED BALANCE SHEET OF
COMMERCIAL BANKS
MILLION POUNDS

	80	81	82	83	84	85	86
ASSETS							
RESERVES	196.3	391.3	408.3	826.2	936.7	2009.4	2694.7
FOREIGN ASSETS	217.5	278.8	375.9	532.3	666.5	1545.1	1234.8
CLAIMS ON GOVT.	186.3	284.9	465.7	93.7	96.3	100.4	74.6
CLAIMS ON PRIVATE SECTOR	592.9	777.5	1142.5	1376.9	1609.2	1882.2	2638.0
LIABILITIES							
DEMAND DEPOSITS	540.4	653.3	884.1	1164.9	1326.3	1925.1	2616.8
TIME AND SAVINGS DEPOSITS	181.8	288.2	465.3	761.0	852.1	1861.9	1836.9
FOREIGN LIABILITIES	72.0	132.3	158.6	152.3	177.8	538.8	486.4
GOVT. DEPOSITS	12.8	25.1	12.4	45.7	56.8	265.0	683.1
CREDIT FROM CENTRAL BANK	53.0	70.9	92.9	147.5	126.5	30.5	11.6
CAPITAL ACCOUNTS	28.5	45.4	94.3	246.7	326.0	651.8	701.3
VALUATION ADJUSTMENTS	NA	NA	NA	0.0	0.0	300.0	300.0
OTHER ITEMS, NET	188.8	316.3	301.1	414.7	578.9	-35.9	6.6

BALANCE SHEET OF CENTRAL BANK

	80	81	82	83	84	85	86
ASSETS							
FOREIGN ASSETS	19.8	15.2	26.9	21.5	22.2	33.9	156.5
CLAIMS ON GOVT.	NA	NA	NA	NA	NA	NA	NA
CLAIMS ON OFFICIAL ENTITIES	376.8	534.2	796.1	472.9	582.2	1146.7	1656.2
CLAIMS ON COMM. BANKS	49.8	66.6	91.1	23.2	146.3	150.0	139.3
CLAIMS ON SPECIAL BANKS	23.0	30.0	30.6	45.0	56.5	71.6	79.3
LIABILITIES							
RESERVE MONEY	751.1	1211.5	1581.9	1740.2	2444.1	3949.5	5614.8
OF WHICH							
CURRENCY OUTSIDE BANKS	508.1	629.7	820.4	1022.2	1247.1	1930.4	2760.1
QUASI-MONEY DEPOSITS	NA	NA	NA	13.3	102.7	101.6	89.2
FOREIGN LIABILITIES	512.1	1243.8	1787.6	2787.9	2876.8	4612.2	5078.6
CAPITAL ACCOUNTS	28.0	18.2	18.9	44.7	42.3	41.6	59.1
RESCHEDULING ADJUSTMENTS	NA	NA	NA	-575.8	-575.8	-743.0	-743.0
VALUATION ADJUSTMENTS	NA	NA	NA	-1532.3	-1532.3	-3209.2	-3415.5
OTHER ITEMS, NET	-87.7	-825.5	-1699.7	-284.0	-565.6	-456.6	-417.4

SUDAN

GOVERNMENT FINANCE
MILLION POUNDS

	80	81	82	83	84	85	86
DEFICIT(-)/SURPLUS(+)	-129.9	NA	-326.4	NA	NA	NA	NA
REVENUE	558.6	NA	839.5	NA	NA	NA	NA
EXPENDITURE	779.7	NA	1198.2	NA	NA	NA	NA
FINANCING							
DOMESTIC	18.0	NA	197.9	NA	NA	NA	NA
FOREIGN	111.9	NA	128.5	NA	NA	NA	NA

INTERNATIONAL DEBT
MILL. US$

	80	81	82	83	84	85	86
TOTAL EXTERNAL DEBT, (EDT)							
LONG-TERM DEBT	3801.8	4540.9	5116.9	5684.2	5663.0	5086.0	NA
PUBLIC AND PUBLICALLY GUARANTEED	3801.8	4540.9	5116.9	5684.2	5663.0	5086.0	NA
PRIVATE NON-GUARANTEED	0.0	0.0	0.0	0.0	0.0	0.0	NA
USE OF IMF CREDIT	341.7	482.4	501.1	624.3	598.1	664.9	NA
SHORT-TERM	536.0	736.0	660.0	440.0	404.0	581.0	NA
TOTAL LONG-TERM DEBT							
DEBT OUTSTANDING AND DISBURSED	3801.8	4540.9	5116.9	5684.2	5663.0	5086.0	NA
DISBURSEMENTS	696.0	571.0	574.9	436.4	181.4	108.8	NA
PRINCIPAL REPAYMENTS	59.2	54.7	97.8	49.7	39.8	63.5	NA
NET FLOWS	636.8	516.3	477.1	386.7	141.6	45.3	NA
INTEREST PAYMENTS	44.8	89.8	16.7	37.1	64.6	66.8	NA
NET TRANSFERS	592.0	426.5	460.4	349.6	77.0	-21.5	NA
TOTAL DEBT SERVICE	104.0	144.5	114.5	86.8	104.4	130.3	NA
PRINCIPAL RATIOS							
TOTAL EXTERNAL DEBT							
EDT/XGS)	454.1	455.3	683.6	835.2	845.6	759.7	NA
EDT/GNP)	67.3	67.1	78.5	91.6	92.3	79.9	NA
INTERNATIONAL RESERVES	48.7	17.0	20.5	16.6	17.2	12.2	NA

J. Zaire

1. MACROECONOMIC SURVEY

a. Introduction and Discussion of Key Problems

After Independence in 1960, the Zairian economy experienced a period of relatively high growth in the late 1960s and early 1970s (7% p.a. growth in GDP in real terms from 1967-74) followed by a crisis period in the mid-to-late 1970s (GDP in constant prices fell to about 10% lower than 1972-74 levels). The 1980s have seen major efforts to stem economic deterioration and to redesign development policies and priorities. As in many African countries, the decade following independence was a period of rapid expansion of the public sector and large-scale investments with substancial foreign assistance and commercial borrowings. Zaire's major exports, copper and coffee, benefitted from strong world prices during this period. However, by 1974, when copper prices took a plunge and general terms of trade began to deteriorate, the effects of an ambitious and inadequately controlled public investment program began to strain the economy. In 1979, "zairianization" of major sectors of the private economy (the takeover of many foreign-owned businesses and nationalization of a number of large-scale enterprises) and the troubled implementation of the new currency program (requiring an exchange of old notes for new ones) left the private economy in turmoil. The Government reacted to this economic crisis by intervening with controls to stabilize prices, buoy markets, and regulate the allocation and cost of credit. In 1980-81, the economy recovered slightly, and in 1981, the government deregulated most of the agricultural prices and began a process of turning productive activities back to the private sector. Copper and cobalt prices fell again in 1982, and by September 1983, the government decided to undertake major policy reforms to stabilize and restructure the economy.

The stabilization program which began in 1983 has been strongly supported by a series of IMF standby agreements, debt rescheduling, World Bank/IDA structural adjustment and sector credits, and the USAID through its African Economic Policy Reform Program (AEPRP) grants. Measures taken since 1983 as part of the IMF stabilization programs include: (1) devaluation of the zaire by 80% vis-a-vis the US dollar (500% in local currency terms) and since February 1984, the maintenance of a floating exchange rate determined through a weekly interbank foreign exchange auction managed by the central bank, Banque de Zaire (BDZ); (2) deregulation of interest rates on deposits and lending (with the exception of non coffee agricultural loan rates fixed at 30% p.a.); (3) dismantling of controls on most producer prices; (4) limitation of overall domestic credit ceilings and monetary growth; (5) elimination of most restrictions on imports and (6) introduction of measures to improve the budgeting process and control expenditures.

310

These measures resulted in good progress toward stabilization of major macroeconomic imbalances. The current account deficit of the balance of payments was reduced from a level of 13.8% GDP in 1982 to 4.1% in 1985; the fiscal deficit was reduced from SDR 598 million, equivalent to 11% of GDP in 1982, to SDR 423 million, equivalent to 6.1% of GDP in 1985; in addition, the government was successful in reducing its borrowing from the domestic banking system from a level equivalent to 6.3% of GDP to 1.9% of GDP over the same period. However, overall economic recovery was not as strong as anticipated. GDP grew at an average of only 2.5% p.a. between 1984 and 1986. In mid-1986, the government briefly abandoned the unpopular austerity program, reintervening with informal exchange rate controls and exceeding agreed fiscal and monetary targets. As a result, the fiscal deficit ballooned again to about 11.8% of GDP compared to a surplus of 1.2% of GDP in 1985. There was a resurgence of inflation and the zaire depreciated by about 20% on the parallel market. In late 1986, after stalled negotiations with the IMF, the World Bank, and other donors including the US, the government requested further international assistance in preparing a medium-term program of additional structural reforms. Support for the design and implementation of further reforms is being provided under continuing IMF standby agreements, an IDA Structural Adjustment Credit financing an industrial sector reform program and a USAID AEPRP Structural Adjustment Support Grant.

b. Medium-Term Development Objectives

With a population of 30 million and a GNP per capita of approximately US$ 140 equivalent (1985 figures), Zaire remains one of the poorest countries in the world. Agriculture accounts for 30% of GDP, mining and mineral processing (copper, cobalt, diamonds) accounts for about 33%, industry and construction, 10%, and government and other services, 27%. Mineral exports account for about 80% of total export earnings, followed by coffee, at 10%, and other agricultural products (wood, rubber), at 10%. In comparison to many other African counties, Zaire has a relatively diverse resource base; however, its large size, poor infrastructure, land-locked position, and limited trained manpower resources constitute substancial constraints to development. The government's medium-term growth strategy is based on (1)private sector promotion for the diversification of export earning activities and expansion of agriculture and import-substition industries, and (2)improvement in public sector management. Key to future agricultural development is agricultural research, rehabilitation of large-scale agricultural production (rubber, coffee, cotton, and sugar), improvement in rural infrastrucure, provision of input and marketing services and credit, as improved technical packages become available. In the manufacturing sector, the problems of low capacity utilization need to be addressed through greater foreign exchange and term credit availability and through realignment of the incentive structure. Strengthening public-sector management will begin with the adoption of a comprehensive public investment

311

program (PIP) and efforts to limit total expenditures on non core programs.

c. Implications for the Financial Sector

The current macroeconomic situation and medium-term outlook have rather serious implications for financial sector growth and contribution to development. The chronic imbalance in the fiscal deficit, including an extremely heavy external debt burden, imply that government will continue to be a net drain on overall financial resources for at least the medium term. The government is heavily dependent on mineral exports, and without successful diversification, the prospects for improving government revenue and higher overall GDP are slim. Thus, the timely implementation of other needed structural adjustments will depend to a large extent on massive debt relief and a serious rationalization of government expenditures. The role of the financial sector in the adjustment process will depend upon the extent to which (i)the government can make more credit available to the private sector, and (ii)the banks are encouraged to participate in greater mobilization of savings and more risk taking in their lending activities. Changes in current banking sector regulations, reduction in inflation and improvement in the general investment climate are preconditions for greater financial sector development and involvement in the development process.

II. FINANCIAL SECTOR

a. Structure

The structure of the domestic financial system is dominated by the central bank, the Banque de Zaire (BDZ), which designs and implements monetary policy, regulates financial institutions, issues domestic currency and manages the foreign exchange market and the country's foreign exchange reserves. The BDZ also performs a number of banking services, including acting as the principal bank for parastatals, providing a rediscount window and regular short-term advances for financial institutions. The BDZ has over 3,000 employees in Kinshasa and has eight regional offices and 32 agencies. It is managed by a Governor, Vice-Governor and Principal Director and is organized into 19 departments.

The formal financial system consists of nine commercial banks (including four large banks, with varying degrees of government ownership and five foreign banks), two specialized development banks (the Banque de Credit Agricole, BCA, which lends for agricultural development and the Societe Financiere de Developpement, SOFIDE, which supplies medium- and long-term credit to national businesses), two non bank financial institutions specialized in construction and real estate, the public savings bank (Caisse Generale d'Epargne du Zaire, CADEZA), a single national insurance company (Societe Nationale d'Assurance, SONAS), a post office savings institution (Comptes

312

Cheques Postaux, CCP), and a national social security fund (Institut National de Securite Sociale). A general picture of the relative importance of different segments of the financial sector in total private sector lending is given in Table 1.

Table 1: Distribution of Private Sector Lending (estimate as of December 31, 1984)

	Z million	Mkt.Share (%)	No.instits.
Banque du Zaire (BDZ)	39	1	1
Commercial Banks	4233	70	9
Development Banks	1495	25	2
Non-bank institutions	148	2	6
Informal COOPEC	150	2	12
Total	6065	100	30

Source:World Bank, Staff Appraisal Rept, Zaire: Small Enterprise Development Project, Feb 12, 1987

b. Commercial Banks

Within the commercial banking sector, there is a high degree of concentration, both institutionally and geographically. The four largest banks, Banque Commerciale Zairoise (BCZ), Banque du Peuple (BDP), Banque de Kinshasa (BK), and Union Zairoise de Banques (UBZ) account for about 87% of total commercial bank deposits; the foreign banks controlling the other 13% (see Annex for detailed desription of the commercial banks). With the exception of the BK, which was formed in 1969, these large banks were established before Independence. Salient features of the banking system are provided in Table 2 and the relative shares of deposits and lending are given in Table 3. Prior to 1960, the BCZ led the market with approximately 80% of all deposits; it has given up market share mainly to the BDP and the foreign banks, and now controls about 40% of the market. The BK went into default in 1984, and although it has been propped up by the central bank since that crisis, its future is highly uncertain. The four large banks have expanded their branch network significantly over the last two decades, from 44 in 1969 to 113 in 1986; however, 16 of these branches are in Kinshasa and the rest are located in a dozen regional towns. A more significant measure of this concentration is the geographic distribution of deposits; Kinshasa banks account for about 90% of time deposits and 68% of term deposits, and this pattern has been quite consistent over the last decade.

The inter bank money market is rudimentary and currently limited to a small amount of inter bank deposits (the total size in 1986 was estimated at about Z 500 million). Measures are currently being discussed to develop the money market, including: lifting reserve requirements on inter bank deposits, allowing non bank institutions to participate, posting of inter bank rates on a weekly basis, and BDZ participation in the market to complement existing rediscounting and advance facilities.

c. Development Banks: SOFIDE AND BCA

SOFIDE was established in 1970 to respond to the demand for term credit in Zaire. Its major shareholders include the government, the IFC, several international banks and private shareholders. It is considered highly successful in fulfilling its objectives and is well managed. Total assets at the end of 1985 were Z 3,604 million. Loans outstanding at that time totaled about Z 2.8 billion, equivalent to about one-third of all private sector lending. SOFIDE provides an estimated two-thirds of all term lending. It has benefitted from regular increases in its capital, and its loans are largely externally financed, which mitigates the problems of obtaining foreign exchange. The institution has a staff of about 220 and 5 branches (including Kinshasa).

The Banque de Credit Agricole (BCA) is a recent creation of the goverment by the law of October 21, 1982. It started operations in 1983 with the dual function of commercial bank and development bank. Its objectives included the provision of short-and long-term loans for production as well as other agricultural sector activities. As of the end of December 1985, it had total assets of Z 279 million. Up until 1987, it has benefitted from the mandatory deposits of the "Fonds de Convention de Developpement;" however, there is some question as to whether this practice will continue. The bank had a staff of about 100 at the end of 1986, including about a dozen management-level personnel. To date, the performance of the BCA has been disappointing. The bank has made few loans to agricultural producers, and overall, there appears to be little differentiation in BCA's agricultural sector lending from that of other commercial banks. The future of the bank is highly uncertain at this time. There have been several studies on this question, one by the UNDP in 1984 and a more recent one by the FAO in early 1987 (these were not available for consultation under this study). Future options that have been discussed include: (i) increased specialization in medium-and long-term development lending, for which long-term external funds would be sought; (ii) focusing exclusively on short-term agricultural lending; and (iii) developing a special banking relationship with the emerging cooperative sector. It is our opinion that none of these proposed undertakings is feasible or advisable given the financial and management capacity of the BCA.

d. Major Nonbank financial institutions - CADEZA and SONAS

The Caisse d'Epargne du Zaire (CADEZA) was established in 1950 under the colonial administration as a public savings institution. It is typical of other similar institutions in Africa created as vehicles for mobilizing excess public liquidity and rechanneling this into long-term public infrastructure projects. The traditional image of these institutions has been one of service and stabililty. CADEZA has an extensive network of small offices throughout the country (70 branches as of 1985),

314

and interest rates are fixed at levels higher than the commercial banks to attract term deposits. Under the colonial regime, CADEZA benefitted from a policy requiring public organizations and "collectivites" to place their deposits with the Caisse; at Independence, this policy was reversed, and CADEZA's capacity to fund large investment programs was substantially reduced.

Management policies pursued since that time have gradually eroded the financial stability and public confidence in the institution. Chiefly responsible for this decline are: (i) the buildup of an unsustainably high cost structure, (ii) the decision to diversify lending from the traditionally long-term, low risk areas of construction and guaranteed public works projects into parastatal loans which have become nonperforming, and other areas for which the institution has little traditional experience and poor management. Excess funds have been invested shortterm in bank deposits and, most recently, in the new treasury bill issues, thus negating the purpose for which the savings were originally mobilized -- to transform these into long-term investments. In recent years, the deposit base of CADEZA has declined in real terms, and cumulative operating losses exceeded Z 150 million at the end of 1985, requiring BDZ to pump in large subsidies.

The future of CADEZA is currently under review. It has been a critical institution in the past for mobilizing public savings, particularly in the rural areas, and the funding of long-term public sector projects. Under the present circumstances in Zaire, there is a continuing need for a such an institution, as neither the commercial banks nor the cooperative sector is prepared or has the capacity to undertake the financial intermediation role originally intended for CADEZA. However, the future of this effort would depend on a major restructuring of CADEZA, initially, a crash program to halt further deterioration, including an immediate freeze on all new lending, intensified efforts to collect overdue loans, reduction of costs, a comprehensive financial and management audit, and development of an overall strategy and organizational plan consistent with the return to a set of limited and financially sound objectives of a public savings institution.

The Societe Nationale d'Assurance (SONAS) was launched in 1966 and exercises a legal monopoly in the insurance business. It has built up a staff of over 1,600 persons and has offices in Kinshasa and six regions. SONAS has shown an extremely poor record of performance. It has the reputation of providing inadequate coverage for risks, being slow to issue payments, and having no credibility with the banks, which means that insurance policies are not often accepted as loan collateral. Its continued dependence on reinsurance for its profitability reflects the fact that the SONAS has not yet developed the internal management capacity to assess and arbitrate the risks of its business. In the larger context of the financial system, the

315

SONAS has not fulfilled the traditional role of the insurance sector, which typically provides (i) a means of transforming savings (i.e.premiums) into long-term investments, (ii) liquidity to the banks in the form of long-term deposits, and (iii) insurance to mitigate the risks of new investments. Recent studies (one by the Belgian firm, Henrijean, another by the UNDP) have recommended (i) that the SONAS be restructured to reduce costs, change the basis on which premiums are calculated, and strengthen management, and (ii) that SONAS's monopoly in the industry be abolished and that other firms be allowed to enter the market.

e. The Semi-formal Financial Sector

The cooperative financial system has come to play an increasingly significant role in the rural areas, particularly given the decline of CADEZA and the Postal Checking system in recent years. These cooperative savings and credit societies, referred to as COOPEC ("Cooperatives d'epargne et de credit") have been in existence for many years, founded and assisted by missionaries and other nongovernmental organizations. They are largely unregistered and do not pay taxes; as cooperatives, they come under the jurisdiction of the Department of Agriculture, although draft legislation has been prepared which would bring the COOPEC under joint supervision of the Department of Finance and the BDZ in addition to the Department of Agriculture. It is estimated that there are about 225 localized COOPEC, representing over 350,000 mmembers. These cooperatives are managed by professionals hired from outside the membership and a board of directors elected from the membership. The COOPEC have recently organized into 12 regional funds; information is not available on the nature of management and business activities conducted at the local and regional levels.

The main function of the COOPEC to date has been to bank the savings of their memberships; deposits earn about 7% to 8% p.a. (below the rate of inflation and formal financial institutions' deposit rates). Total resources of the COOPEC are estimated at Z 600 to 800 million, equivalent to 5% to 7% of total commercial bank deposits in 1985. These societies are engaged in limited and cautious lending to long-standing members, mainly for short-term consumption loans; member loans are secured in part by the members' deposits and by group guarantees. Excess deposits of the COOPECs have been put into bank deposits and, more recently, into treasury bills, which have proven highly remunerative for the cooperatives. Information on lending activities and performance of these funds is not available; however, this model of mutual savings and credit societies has proven successful in many developing countries.

The further evolution of these institutions will depend largely on the degree of autonomy accorded them by government and on their ability to prudently manage their own development. Their success to date can probably be ascribed to their highly localized character, which has fostered membership cohesiveness

316

and confidence and strong, watchdog management. Government efforts to regulate this sector, while justified in the concern for proper financial management, full disclosure and contribution to taxes, should seek to support the unique and successful features of this spontaneous, localized movement. There have been recent recommendations to the effect of creating a national federation, including the central pooling of cooperative resources to improve allocative efficiency of the resources mobilized. Such measures could, however, be disastrous for the cooperative movement, because it would remove individual members and cooperative managers from the sphere of direct involvement in decisionmaking, risking loss of local confidence in the institution and removal of peer group support and pressure for loan repayment. It is, therefore, recommended that the ongoing experience of regionalization of the COOPEC be first consolidated, and then carefully evaluated prior to any further changes in the system.

f. Financial Sector Regulation

i. Introduction

The formal financial sector is regulated under provisions of the Banking Act 72/004 of January 14, 1972 and periodic instructions and circulars. The Banking Act addresses the issues of (i) registration and licencing of banks and nonbank financial institutions, (ii) minimum capitalization and other startup requirements, (iii) sound management practices, (iv) reports and certification of accounts, (v) powers of inspection, control and intervention in situations of crisis. Periodic instructions define government policy regarding reserve requirements, interest rates, credit allocation and management, deposits, and use of central bank rediscounting and advance facilities. Regulations regarding foreign exchange and international transactions are detailed in the BDZ circulars.

The major instruments of monetary and credit policy have been mandatory reserve requirement and credit controls, including ceilings on total lending and, at times, sectoral lending requirements for banks. Application of these instruments has varied significantly since 1970, when the reserve requirement was used chiefly as a means of credit control. In 1976, this requirement was briefly dropped in favor of a more directed policy of credit controls; however, three years later in 1979, the reserve requirement was reinstated in tandem with credit controls. During this period, interest rates on deposits and lending and the exchange rate were also fixed by government, resulting in a highly structured and regulated financial system. The stabilization reforms of 1983 included the elimination of selective credit controls, deregulation of interest rates and the establishment of a floating exchange rate. However, the government has maintained a policy of high reserve requirements coupled with a complicated system of credit allocation, involving credit ceilings for individual banks and prior central bank approval for noncoffee agricultural loans and medium- and

31

long-term lending which is not subject to credit ceilings.

ii. Reserve Requirement

The level of the reserve requirement and the basis for its calculation has changed a number of times. Currently, banks are required to hold 30% of all deposits, excluding interbank deposits, but including provisions for documentary credits (bank clients are required to place on deposit an amount equal to 100% of the value of the expected imports) in a nonremunerative account with the BDZ. The level of the reserve requirement has been as low as 15% and as high as 45% in February 1986; it was reduced to 35% in late 1986 and again to its current level in early 1987. Banks cannot use treasury bills or long-term obligations to meet this requirement. The BDZ monitors this requirement on a weekly basis; a stiff penalty equivalent to 60% p.a. is calculated on the basis of the amount of a bank's weekly deficit.

This level of reserve requirement is not only extremely high compared to most other countries in Africa, it is also one of the most rigidly constructed, particularly as regards its funding requirement. There are a number of undesirable effects of the present system. First, the magnitude of this effectively immobilized and nonearning asset substancially increases banks' marginal costs of mobilizing funds, thus decreasing their motivation to seek out new deposits and certainly dampening competition among institutions for deposits. Second, these increased costs are directly passed on to the clients. Third, the policy discriminates against banks whose business requires mobilization of resources; in effect, the banks involved primarily in foreign transactions are able to meet their resource needs by requiring clients to put up 100% of the cost in local currency in advance; thus, foreign trade is favored over domestic business and production. Fourth, this policy is highly inefficient from the standpoint of the economy, because it effectively transfers one-third of the banking system's funds (mobilized at relatively high cost) out of normal, and relatively efficient channels of resource allocation to the central bank, which uses these zero cost (to the central bank) funds according to a different and often noneconomic set of criteria.

iii. Credit Ceilings and Credit Allocation

Since 1983, the government, in agreement with the IMF, has set strict ceilings on total credit. While selective credit controls on individual bank's lending were abolished, the government divided the total credit allocated for private sector lending into two parts, one portion to be directly allocated to banks ("credit repartis") together with specific individual bank lending ceilings, and the other unallocated ("non-repartis" or "hors plafond") portion to be retained in the BDZ and allocated to banks on a case-by-case basis for lending to priority sectors, noncoffee agriculture and medium- and long-term loans (all trade-related loans excluded). Table 4, which gives the

318

breakdown of total credit channeled through the banks under the present system in recent years, shows that the percentage administered by the BDZ ("credit non-repartis") has grown to over 40%.

Table 4: Allocation of Credit to the Banking System

(Z billions)

	1982	1983	1984	1985	3/86
Allocated (repartis)	1.409	1.996	2.664	3.195	3.780
Unalloc. (non-repartis)	379	832	1.499	2.232	2.479
Total	1.789	2.749	4.163	5.428	6.260
%unallocated	21%	30%	36%	41%	40%

Source: Garson,p92

Administration of the credit ceilings and the reserved portion of credit has proven extremely complicated and cumbersome. Individual bank credit allocations subject to ceilings are calculated on the basis of the bank's volume of deposits plus equity in the previous six months; no account is taken of banks' records of lending, or whether they fully utilize their credit quota. This tends to penalize new banks with a smaller deposit base and limited retained earnings, thus reinforcing existing patterns of concentration and the imbalance in lending between domestic and international business. The total credit ceiling, while known at the beginning of each year, is not translated into a fixed, one-year credit limit to individual banks; rather, the BDZ informs banks on a trimester basis (often late) of their remaining credit limit. Individual bank ceilings are reinforced on a weekly basis, with a 7% weekly penalty charge on any excess over the ceiling. Penalties are not, however, charged on "face-to-face" credits (referred to as off balance sheet or "hors bilan" credits) which are intercompany loans carrying a bank guarantee. An analysis of recent bank lending shows that banks have underutilized their quotas by as much as 15% to 20% (Garson, p.88). Informed sources indicate that underutilization is partly due to the uncertainty resulting from the confusing administration of the present system.

Commercial bank lending for loans over one year or loans to noncoffee agriculture are not subject to the credit ceilings but require prior approval by the BDZ, which manages the nonallocated portion of credit. The credit approval process is so lengthy and uncertain that most banks seek out a positive verbal reading on a prospective loan before they even begin to process a loan application. The process can take up to three months, and an approval may be further delayed by the granting of only partial or delayed financing by the BDZ.

In summary, the present credit allocation mechanism has major shortcomings as a tool of government monetary and credit policy.

319

While it has served as a rudimentary means of controlling growth of domestic credit, it has achieved this at the expense of added confusion, higher costs of bank lending and less autonomy in the banking system. In addition, it has failed to achieve its objective of promoting greater investment in priority sectors; quite the contrary, the policy has increased the costs to the banks of agricultural sector and term loans, and encouraged banks to expand into the comparatively unregulated business of signature loans and other off balance sheet transactions which are not subject to the ceilings or to prior BDZ approval. Perhaps the greatest shortcoming of the current system is that it perpetuates a means of government financing that bypasses the banking system, and in doing so, impedes further development of the financial system.

iv. Interest rates

Interest rates were deregulated in 1983, with the exception of agricultural rates which were fixed at 30% p.a. Current rates are publicly announced by only a few banks; others discuss their rates on a case-by-case basis. Bank rates on term deposits were forced up to levels of 35% to 37% (for 6 and 12 month deposits) as a result of the competition from treasury-bills introduced in 1984 with rates ranging from 40% to 45% in 1984 to 30% to 35% in 1986. Rates on term deposits have been positive in real terms over the last few years (inflation is estimated at between 30% to 35%); however, rates on deposits of up to 3 months remain highly negative, in the nominal range of 14%-17%. (sight deposits earn****). A schedule of commonly applied lending rates and commissions as of November 1986 is given in Table 5.

Table 5: Interest Rates Prevailing in 1986

Type of Credit	Interest rates	Commissions
Short-term advances	32-37% p.a.	*1% per quarter on original amount
Short-term overdrafts	34-35% p.a.	*1% per quarter on highest overdraft
Medium-term loans	32-40% p.a.	*1% per quarter on outstanding amount
Guarantees	-- --	*0.8%-1.5% per quarter

Source: World Bank, Staff Appraisal Report, Zaire: Small Enterprise Development

An 18% turnover tax (CCA) on interest is charged, putting the effective cost of borrowing in the range of 45% to 51%. With inflation at about 30% in 1986, real lending rates are clearly positive. There is little difference between interest rates on short-and medium-term loans which can be explained by the fact that (i) most medium-term loans are still only 1 to 2 years, (ii) often these are granted to existing clients for ongoing businesses for which the bank may be providing an overdraft facility; (iii) banks generally seek prior BDZ approval for the

370

rediscounting of medium-term loans, and thus, bank liquidity risks are minimized, and (iv) medium-term loans may generate new business. Banks reserve the right to adjust interest rates on ongoing loans; stiff penalties are administered on arrears (45% p.a.).

Funding requirements for term loans. The BDZ requires that banks match term lending obligations with corresponding funding resources. Term loans can be covered in one of the following ways: (i) with 200% of the amount of the credit in 3 to 6 month local currency deposits, (ii) with 120% of the credit amount in foreign currency deposits up to 6 months; (iii) with 100% of the credit amount in 6 to 12 months' bonds and/or deposits; and (iv) with 50% of the credit amount in deposits and other obligation of over 1 year. This coverage requirement is not supposed to apply to agriculture and small- and medium-scale term loans, however, in pratice, a special exemption for these types of loans and others is regularly sought. This coverage requirement seems both arbitrary and redundant given other liquidity requirements, including the high reserve requirement. Furthermore, this requirement is met in the breach and does not appear to be enforced by the BDZ.

The Banking Act also specifies a number of operating parameters aimed at reducing risk exposure, limiting potential conflicts of interest (i.e. limiting bank lending to bank directors), establishing total borrowing limits of clients and minimum client financing, among others. These measures are not currently being enforced.

The Banking Act specified minimum capital requirements at Z 125,000, with an obligation to create a legal reserve augmented annually with 10% of bank profits until this reserve was equivalent to paid-in capital. This was recently raised unofficially to Z 250,000, although this may be ultimately legalized at Z 200,000. The capital/asset ratio is a more conventional measure of a bank's abililty to sustain risks and loss of asset value. With the exception of the BACAZ, the commercial banks all have a precariously low capital/asset ratio (see Annex Table), ranging from 0.0024 (BCZ) to 0.05 (BDP), the latter considered only marginally acceptable for a bank in a high-risk environment. The average capital/asset ratio of American banks is about 0.065.

International transactions are governed by a number of circulars, the most important of which, No. 222 of May 10, 1985, sets a limit on the daily net foreign exchange position of banks equivalent to 40% of equity. All excess must be sold to the BDZ at the weekly market rate. This requirement is strictly enforced. Circular No.207 of November 1983, requires that banks seek prior import authorization for a number of specified goods. Since 1983, the BDZ runs a weekly foreign exchange auction in which the banks participate. The chief source of foreign exchange reserves, the central bank plays the critical role in setting the opening and closing rates.

v. BDZ Rediscounting and Advance Facilities

The BDZ provides both a rediscounting facility and options for advances with and without collateral. In principle, the BDZ accepts only short-term instruments (e.g.commercial bills, noninterest bearing treasury bills subscribed to by the banks, and promissory notes) which : (i) have 30 to 180 days to maturity, (ii) are submitted to the BDZ within 160 days of the issue date, and (iii) were properly legalized within 30 days of the contract date. In fact, most forms of comercial bills backing up term loans are accepted for rediscounting. Rediscounting limits are set individually for each bank. As of April 1986, rediscounting rates ranged from 28% on short- and medium-term agricultural loans to 30% on all other loans; treasury bills are rediscounted according to the original yield (there is no secondary market for either the nonbank public t-bills or for the non-interest bearing t-bills subscribed to exclusively by banks). Because of the high costs of these funds, banks' use of this facility has been very limited. Advances to banks from the BDZ, with and without collateral, are also subject to individual bank borrowing limits. Interest rates on collateralized advances were in the range of 23 to 26% as of April 1986; rates on nonsecured advances were 32%. Eligible as collateral are treasury bills, commercial bills or promissory notes related to short and medium-term production business. Collateralized advances are given for 2-day periods and are renewable up to 15 days per month. Noncollateralized advances require the deposit of 120% guarantee in the form of treasury bills. A reflection on the stringent requirements and the high cost of these funds, banks use these facilities only as a last resort. (see Annex, Tables_, from Annexes 14 and 15, Lloveras).

vi. Reporting and Disclosure Requirements.

Banks are required under the Banking Act to submit their accounts to the BDZ by March 31 of the year following the close of their financial year. The accounts must be submitted according to an accepted format and certified by two national firms or by a certified accounting firm appointed by the shareholders. Bank financials must also be published in the Official Gazette and in one national newspaper. All of the foreign-owned banks and at least one of the four national banks are audited by internationally accepted firms. It is generally accepted that local capacity for quality audits is extremely limited. The official Accounting Board ("Conseil Permanent de la Comptabilite au Zaire") is responsible for accounting standards and certification of national accounting firms; however, it has not yet defined procedures and standards for the accreditation of local accounting firms.

The BDZ's reporting requirements are geared primarily to monitoring of specific regulations, particularly compliance with credit ceilings and reserve requirements. In addition to annual reporting requirements for general balance sheet and income

302

statement information, banks must report weekly on the evolution of assets and liabilities and credit approvals; in addition, on a quarterly basis, they must submit data on geographic distribution of deposits. A special Risk Management Unit within BDZ's Credit Department ("Centrale des Risques") requires banks to submit information pertaining to loans over Z3,000. The process of routine monitoring and inspection of the financial system is currently costly and time-consuming, and the results do not provide the BDZ with sufficient information for effective detection or control of financial problems. The system's shortcomings have been underscored by the recent financial crises of several financial institutions, most notably the Banque de Kinshasa (BK-NBK) and the Caisse d'Epargne (CADEZA); in both cases, the central bank has been forced to provide huge recurring subsidies to keep these institutions afloat. The IMF is currently providing technical assistance to the BDZ to rationalize reporting requirements, improve control checks on the data, and and install a computerized monitoring system of key banking ratios. These measures should enhance the quality of BDZ monitoring and inspection.

g. Banking Sector Activities and Resource Mobilization

The credit activities of the banks, as well as their resource mobilization efforts, have to be viewed in the context of financial sector regulations which determine total credit available for lending and define the incentives for banks to undertake different financial operations. On the lending side, total lending to the private sector (excluding "signature credits" for international trade which involve no real disbursement of funds by the banks) represented less than 30% of total net domestic credit over the period 1983-86. (**verify with CEM). The government and parastatals continue to consume the major share of total credit available under the agreed IMF ceilings. The distribution of banking credit within the allocation system is given in Table X, Annex X. On the resources side, there is an equally constraining situation, namely the persistent preference of the population for a high degree of liquidity. It is estimated that approximately 55% of the money supply (M1) (1986 figures) is in cash outside of financial institutions; this percentage has been rising in recent years. Thus, at the present time the activities of the banking system in the overall economy are relatively narrow and future growth potential is constrained, both by government monetary and credit policy and sociological factors affecting the public's savings habits.

Table 6 decribes recent trends in banking sector credit activities, as defined in terms of short- and medium-term disbursed credits (loans) and "signature credits" (nondisbursement transactions). This picture reveals some important facts about the evolving nature of the lending activity in Zaire.

Table 6: DISTRIBUTION OF CREDIT BY TERM
(in Z millions)

Type of Credit	12/82	12/83	12/84	12/85	3/86
Short-term loans	1,535.8	2,245.2	3,190.3	3,820.7	4,522.2
Medium-term loan	253.6	504.2	973.0	1,607.7	1,738.3
Total Loans	1,789.4	2,749.4	4,163.3	5,428.4	6,260.5
Annual % Growth		53.7%	51.4%	30.4%	
Signature cred.	1,377.5	5,349.6	7,144.4	12,729.3	14,816.2
Annual % Growth		188.4%	33.5%	78.2%	
TOTAL	3,166.9	8,099.0	11,307.7	18,157.7	21,076.7
% Loans/Total	57%	34%	37%	30%	30%

Source: BDZ Credit Department

First, signature credits, as a percentage of total credit, have increased dramatically since 1982, from 43% in 1982 to 70% in 1986. This reflects both the lucrativeness and low risks associated with international trade transactions, but also the fact that these credits do not involve any direct disbursement of bank funds and are treated as "off balance sheet" transactions and, therefore, are not subject to regulated credit ceilings. Second, the annual growth in loans subject to the credit ceilings was negative in real terms over this period. Third, the percentage of medium-term loans (over 1 year) has seen a substantial increase from 14% in 1982 to 30% in 1985 (28% by March 1986); however, much of this lending appears to be an extension of the short-term advance or overdraft facility for existing clients.

The sectoral distribution of loans over this same period has remained relatively constant, as shown in Table 7.

Table 7: SECTORAL DISTRIBUTION OF PRIVATE SECTOR CREDIT (%)

Sector	1982	1983	1984	1985
Agriculture	37.4	41.4	45.0	40.0
(foodcrops)	(4.7)	(9.5)	(9.4)	(8.0)
Industry	26.0	22.0	20.1	21.1
Building/constr.	1.5	5.1	3.0	1.4
Transport	5.1	3.2	4.4	4.5
Commerce	21.5	22.0	21.4	31.4
Others	8.5	6.3	6.1	1.6
TOTAL	00.0	100.0	100.0	100.0

Source: BDZ

The portion of credit to agriculture increased marginally over this period, however, credit to foodcrops within the sector almost doubled. This may reflect, in part, the positive influence of Direction des Marches, Prix et Credits (DMPCC), established in 1983 under the Department of Agriculture to develop projections of annual marketing and financing needs by product and region, thereby assisting government to reserve adequate funds under the "nonallocated" portion of total credit to be distributed to banks by the BDZ. The percentage of credit for industry declined by almost 5%, reflecting the uncertain investment climate and the shortages of foreign exchange for parts and imported inputs. The commerce sector gained by over 10% during this period.

Apart from factors of size and geographic coverage, it can generally be concluded that the similarities among the individual banks' practices are far greater than their differences. By far the most important and profitable activity of the banks is the international trade business, involving documentary credits (signature credits), import financing guarantees, and foreign exchange transactions. It is estimated that international transactions account for 50 to 90% of the profits of commercial banks. The foreign-owned banks deal almost exclusively in international transactions. The banks currently handle all imports, except oil; however, they benefit from less than half of the exports (the BDZ manages all the mineral exports of Gecamines, which accounted from between 50 to 70% of the country's exports in the period 1982-85). As a result of this chronic shortage of foreign exchange, banks ration their credits in an extremely conservative fashion and require clients to bear all of the foreign exchange risk in import transactions.

Short-term (less than one year) and medium-term loans (largely 2 to 3 years) represent a decreasing proportion of total bank business in recent years. Short-term loans represent about 70% of disbursed loans. The most commmon forms of short-term credit are overdrafts, advances (secured by a promissory note or bill of exchange), and commercial discounts of short-term trade bills. Most loans are made to companies; with the exception of limited personal loans to bank employees, there is virtually no lending for personal consumption needs. Medium-term lending carries with it the added bureaucracy of the BDZ's prior approval, since loans over one year fall under the unallocated credit category administered by the central bank. Recipients of medium-term loans tend to be large companies; one source indicated that 90% of these loans go to companies with fixed assets of more than US$350,000 equivalent (Lloveras, p 25). The majority of the term lending in Zaire is done by SOFIDE; as of the end of 1985, loans outstanding stood at Z 2.8 billion compared to Z 1.6 billion from all commercial banks.

Loan collateral. Acceptable forms of loan collateral are few. The most common forms are mortgages, overseas guarantees, and floating charges on inventory or other assets. The practice of using insurance policies is extremely limited, because of the

poor record of the national insurance monopoly, SONAS, in meeting its obligations. As in many African countries, land titles are not available, which further handicaps the development of rural credit. Due to high risks of nonenforceability of most forms of security, banks tend to restrict lending to a well-established client base.

A loan guarantee fund for small-scale businesses was established in 1986 under the government's Office de Promotion des Petites et Moyennes Entrepriese Zairoises (OPEZ). Its initial capital of Z 20 million was financed by the Fonds de Conventions de Developpement (FDC), for a total guarantee capacity to Z 200 million (with a one-to-ten capital/risk ratio). The fund covers up to 80% of the principal and interest of a project. There are limitations of up to Z 5 million for agricultural and small-scale industry projects, Z 2 million for service industries and Z 1 million for projects involving trade. Clients pay 3% p.a. on the guaranteed amount, plus a service fee of 1%. It remains to be seen how this fund will be put into practice and to what extent it will relieve the reticence of commercial banks to lend to these nontraditional sectors.

Table 8: Trends in Bank Deposits
(figures in Z millions)

	1982	1983	1984	1985	3/1987
Sight deposits	4,114	7,658	8,593	9,927	10.985
Annual % growth	---	86%	12%	15%	---
Term deposits	549	683	994	1,046	1,102
Annual % growth	---	24%	45%	5%	---
Total deposits	4,663	8,314	9,587	10,973	12,087
Annual % growth	---	79%	15%	15%	---
Term deposits/Tot	12%	8%	10%	9%	9%
Est. inflation		76%	52%	30%	30%

Source: BDZ and Garson, p.61

As Table 8 above indicates, the growth in total deposits (i.e. sight deposits and term deposits) has been negative in real terms since 1982, and the relative percentage of term deposits in the total has declined slightly.

There are a number of explanations for these trends. First, the regulatory environment, particularly the heavy reserve requirements and the credit ceilings, pose significant disincentives for banks to mobilize additional resources. Second, the new nonbank public treasury bills issued in 1984, while successful in forcing banks to raise deposit rates, compete directly with the banks, and have taken away bank business. Third, the recent financial crises of the Banque de Kinshasa and the CADEZA have heightened public awareness of instability in the

financial sector, thus contributing to a preference for high personal liquidity. Finally, a further possible explanation is in the general conservativeness of the commercial banking system in seeking new deposits and business, as suggested by the consistency of resource mobilization patterns since the late 1960s despite a 150% increase in the number of brank branches (Garson, p. 65) and the addition of a number of new institutions. This might suggest that the present restrictive conditions noted above may simply reinforce the conservative and noncompetitive nature of the banking community.

3. MACROECONOMIC POLICIES AFFECTING THE FINANCIAL SECTOR

a. Monetary Policy

The present monetary situation in Zaire is characterized by an unusually high degree of liquidity being held outside of the formal financial sector. This reflects a number of factors, including: lack of public confidence in the financial institutions and poor access to banking facilities in many parts of the country, high inflation, and the needs of individuals and businesses to maintain substantial holdings in cash, and inadequate incentives, and mechanisms for effective mobilization. A high preference of liquidity is not uncommon among developing countries; however, money supply indicators reveal that the percentage of cash holdings outside the banking system is increasing and that the growth in cash holdings has been larger than the growth of deposits.

In an attempt to curb inflation and increase control over the money supply, the government, in consultation with the IMF, instituted credit ceilings and monetary growth restrictions. In 1984, the government also issued a new series of Treasury bills for public subscription with the multiple objectives of draining excess liquidity from the system, introducing a new means of deficit financing, and forcing banks to raise their deposit rates. (nb. These new T-bills are not to be confused with the nonremunerative T-bills subscribed to by the banks). While the new Treasury-bill experiment had some positive aspects, it has been argued that the policy did not achieve several of its major objectives and that it had unintended negative effects on the financial system. The new T-bills are of short maturities (1 to 6 months) with a face value of 10,000z and a yield set by the BDZ. There is no secondary market for these bills and banking institutions are not allowed to subscribe. On the positive side, the high rates on the new bills did have the effect of forcing bank term deposit rates up and into a positive range. In addition, the T-bills lent a measure of public confidence to the government's credibility, which has been weakened by the financial crises of several government financial institutions.

Unfortunately, this experiment did not prove a good instrument for reducing private sector holdings of cash. It is questionable whether the T-bill subscriptions, as issued, constitute an effective and cheaper way of financing the

government deficit (Garson pp 18-28). By offering more attractive short-term returns, this policy has also had the detrimental effects of (i) competing with CADEZA for deposits, thus further exacerbating the liquidity problems of that institution and (ii) effectively transforming potentially long-term savings deposits into short-term uses, i.e. contributing to disintermediation.

b. Government Financing

Government deficit financing in Zaire largely bypasses the financial sector. In 1984-85, about 74% of the net financing needs of Z 4.05 billion were covered by government drawings on the BDZ; Treasury bills financed about 13%; foreign aid accounted for about 11%, and direct commercial bank borrowing accounted for only about 2%, as has been the case throughout the 1980s. This method of government financing is made possible by the current system of credit allocation, in which the BDZ maintains control over all credit which is not specifically allocated to the banks and is distributed on a case-by-case basis. In effect, bank credit allocations are the residual after government financing needs are met. Not only is the degree of government "crowding out" of private sector investment particulary severe in Zaire, the persistence of this method of government deficit financing impedes the development of the financial sector and, in particular, ignores its critical role in mobilizing savings for the development process.

c. Structural Adjustment Programs

The process of structural adjustment is proceeding with strong commitment of government and continuing support of the international aid community. Trade and tax regime reforms are currently being implemented with assistance of the IDA/SAF Industrial Sector Adjustment Program approved in early 1987 and the USAID AEPRP Structural Adjustment Support Grant signed in late 1986. Specific measures supported under these two projects include: (1) a program of tariff reform to gradually lower effective protection and provide more uniformity in the treatment of domestic goods; (2) the phasing out of controls on pricing of industrial products; (3) the elimination of export duties and reduction of other taxes on manufactured exports; (4) a program of tax reform to equalize taxes on domestically produced and imported commodities and further studies to rationalize other elements of the tax system; and (5) support for the Government's new industrial promotion policy, including divestment of a number of state-owned industries. These policy reforms are being complemented by a seventh IDA credit to the development bank, SOFIDE, in support of reforms and new financing to benefit small and medium-scale enterprises.

4. CONCLUSIONS

The government of Zaire has made major efforts since 1983 to correct unsustainable imbalances in the fiscal and current

328

account deficits and to reduce inflation and curb domestic credit expansion. These efforts have been accompanied by important policy changes, particularly the deregulation of interest rates, establishment of a floating foreign exchange rate and elimination of price controls. Extensive adjustments in the tax and tariff regimes and in the incentive structure for industry are under implementation. At the present time, further discussions are underway between the government, the IMF, World Bank and other major donors to define an agenda of further policy reforms and to extend the sphere of structural adjustment.

Further reforms in the financial sector and in the method of government financing are imperative in order to develop more effective financial intermediation and to expand the capacity and the role of financial sector institutions in financing development. At present, progress toward these objectives is constrained by a number of factors, the most critical of which include: (i) Government's continued reliance on the central bank for a large portion of its deficit financing, largely bypassing the banking sector and thereby impeding growth and development of the sector, (ii) the current financial sector regulations, particularly the combination of exceptionally high reserve requirements and a restrictive and cumbersome credit allocation mechanism, which create disincentives for savings mobilization and priority sector lending and discourage competition and innovation in the banking sector, and (iii) mounting instability in the financial sector that erodes public confidence in the formal financial system and reinforces the public's preference for a high degree of liquidity, thereby limiting the potential for financial intermediation. Finally, it must be underscored that reforms in the financial sector must be accompanied by successful efforts to reduce high levels of inflation and to improve the general climate for investment in productive enterprises.

RECOMMENDATIONS

I. The banking sector should be more closely integrated with the financing of government in order (a) to make more evident the relationship between government financing and national monetary and credit policy as it affects the rest of the economy, and (b) to develop the role of the financial sector in financial intermediation. In order to achieve this integration, the following measures are recommended:

-The functions of the central bank should be reviewed and BDZ's banking services for parastatals reduced and turned over to the banking institutions;

-The reserve requirement should be lowered and a portion of these reserves remunerated at a minimum level;

-The distinction between the bank-subscribed Treasury bills and the nonbank public Treasury bills should be eliminated and new Treasury bills issued at auction; the banks should be

encouraged to subscribe by making these T-bills eligible for partial fulfillment of banks' reserve requirements; government should promote the development of a secondary market for treasury bills.

These recommendations, in combination with greater rationalization and reduction of public sector expenditures, should broaden the scope for financial sector participation and private sector investment.

II. Global credit ceilings should be administered in such a way as to promote new investment in productive sectors and to foster competition among banks. The following are the subject of current discussion between the government and the World Bank and the IMF:

-The current credit allocation mechanism should be redefined and the distinction eliminated between credit subject to bank ceilings ("repartis") and other reserved credit ("non-repartis" or "hors platfond") allocated by prior approval of the central bank. The present system has not served the objective of directing more credit to priority areas (agriculture and term lending), rather it has encouraged banks to increase "off balance sheet" transactions and raised the effective costs of priority sector lending to the bank and to the borrower. In addition, the ambiguities and confusion resulting from the present administration of the credit ceilings has resulted in a severe contraction of bank lending, reinforcing conservative loan rationing and discouraging new efforts at savings mobilization.

-The remaining interest rate restriction for loans to noncoffee agriculture should be removed, since this has served mainly to limit bank credit to the sector in preference for more remunertive lending options at higher, unregulated interest rates.

III. The stability of the financial system needs to be reestablished and public confidence in the institutions revived. This will require:

-Continuing efforts to reduce inflation;

-Improving central bank monitoring and inspection;

-Revising minimum bank financial and operating standards, including minimum capitalization and capital/asset ratio requirements, minimum liquidity requirements, and reserve requirements for bad and doubtful debts; mandating the recapitalization of a number of institutions; enforcing stiff penalties for noncompliance with safety ratios.

-Restructuring of critical public financial institutions as warranted by their unique role in the financial system.

In the case of the public savings institution, CADEZA, it should be returned to its original mandate as a fund-raiser for public infrastructure and service projects. This calls for a complete reorientation of its present activities, management strengthening and an aggressive campaign to regain public deposits.

In the case of SONAS, the national insurance company, institutional strengthening measures should be followed by the removal of its monopoly position in the insurance market to encourage competitive business practices.

In the case of the Agricultural Credit Bank, BCA, there is not a clear case for maintaining the institution; its current business in the agricultural sector is not significantly different from that of the commercial banks, and if current interest rate restrictions are lifted on agricultural loans, there is no reason why the commercial banks should not finance viable agricultural enterprises. The agricultural sector is more likely to be assisted through direct government investment in development of new agricultural technology, rural infrastructure, and the removal of other such constraints to agricultural production.

The cooperative sector savings and credit societies should be permitted to develop at a pace consistent with their management capabilities and membership confidence in the cooperative system. Too much government intervention at this stage could undermine local initiatives and dampen commitment by adding unneccessary outside elements and regulation. At this time, government can facilitate this spontaneous movement process mainly through provision of financial management training for the financial personnel of the cooperatives.

BIBLIOGRAPHY

Agency for International Development. "Action Plan - Zaire FY1989." (Washington, DC, 1987).

Ibid. "African Economic Reform Program Structural Adjustment Support Grant." (Washington, DC, 1986).

Bensimon, S. "Marketing in Zaire." (Washington, DC, 1984).

Consul, J.G.P. "Analyse Generale du Systeme d'Intermediation Financiere du Zaire." (Washington, DC, 1986).

International Bank for Reconstruction and Development. "Zaire Staff Appraisal Report - Small Enterprise Development Project." (Washington, DC 1987).

Ibid. "Report and Recommendations on a Proposed Development Credit." (Washington, DC, 1986).

Ibid. "Zaire: Medium-Term Economic and Financial Policy Framework." (Washington, DC, 1987).

J.G.P. Consultants (Garson)."Analyse Generale du Systeme d'Intermediation Financiere du Zaire." (Washington, DC, 1986).

Johnson, O. "Macrodisequilibrium - The Zaire Experience, 1967-81." (Washington, DC, 1982).

Lloveras, Joseph M. "The Banking Sector in Zaire." (Washington, DC, 1986).

Mitchell, P. "The Investment Code of the Republic of Zaire." (Washington, DC, 1980).

Zaire Annex
Table 1

SUMMARY BALANCE SHEETS OF BANKING INSTITUTIONS a/

(Z Million)

	1981	1982	1983	1984	June 1985
ASSETS					
Cash	164	294	260	659	669
Deposits at Central Bank	848	2,105	2,859	5,386	5,893
External Assets	801	636	3,298	3,019	4,200
Credit to the Government	174	174	176	253	284
Credit to public enterpr.	32	15	14	63	22
Credit to the private sector	1,243	1,784	2,757	4,170	4,990
Other assets (net)	256	320	350	-	-
TOTAL ASSETS	3,518	5,328	9,714	13,550	16,058
LIABILITIES					
Demand deposits	2,127	3,781	6,961	8,593	8,919
Time deposits	320	547	683	994	1,155
Government deposits	47	24	91	24	68
Foreign exch. deposits	180	217	209	246	401
Advances for imports	371	85	239	184	780
External borrowings	216	289	753	511	804
Other liabilities (net) b/	-	-	-	1,592	2,144
Equity	257	385	778	1,406	1,787
TOTAL LIABILITIES	3,518	5,328	9,714	13,550	16,058

a/ Includes all commercial banks and BCA.
b/ Of which Central Bank refinancing represented 818 million in Dec. 84 and 2,024 million in June 85.

SOURCE: Banque du Zaïre

Source: IBRD, SAR, SMALL ENTERPRISE DEV'T PROJECT, (1987) p.22

Zaire Annex
Table 3

ZAIRE

Relative Market Shares of Commercial Banks

(%)

	Loans, Discounts, Advances					Deposits				
	12/82	12/83	12/84	12/85	3/86	12/82	12/83	12/84	12/85	3/86
BCZ	38.0	39.5	41.2	44.0	45.3	37.8	34.6	41.4	40.0	39.7
BDP	24.6	24.1	23.5	22.0	22.5	23.0	24.4	21.9	25.5	23.4
B. DE KINSHASA	12.7	13.2	11.9	8.7	7.3	15.1	14.3	13.3	6.4	7.8
UZB	12.5	11.4	12.1	12.4	13.5	12.7	13.0	14.2	15.2	15.2
BACAZ	0.0	0.0	0.0	3.3	2.5	0.0	0.0	0.0	1.6	2.1
BARCLAYS	1.5	1.2	1.4	1.4	1.3	2.5	2.2	1.9	2.1	2.4
BIAZ	1.8	1.7	1.2	1.5	1.4	2.3	2.1	2.2	2.6	2.6
CITIBANK	5.0	4.2	5.0	5.0	4.7	4.6	5.6	2.3	4.7	4.7
GRINDLAYS	1.2	1.1	1.0	0.9	0.8	2.0	1.2	1.2	1.9	2.1

Source: IBRD, SAR, SMALL ENTERPRISE DEVELOPMENT PROJECT (1987) p.71

Zaire Annex
Table 4

Distribution of Bank Deposits by Term

(Z million, End of Period)

	1981	1982	1983	1984	1985	March 1986
Demand deposits	2,197	4,115	7,659	8,832	10,354	11,511
Time Deposits	320	550	683	1,009	1,136	1,188
Of which:						
Up to 1 month	6	9	15	301	90	117
Over 1 month	8	16	0	27	1	2
3 months & over	12	47	28	334	241	181
6 months & over	97	202	97	80	531	564
1 year & over	197	276	543	267	273	324
Kinshasa	1,835	3,578	6,494	6,727	7,428	
Bas-Zaïre	43	68	134	203	245	
Bandundu	24	29	51	63	77	
Equateur	48	74	103	155	147	
Haut-Zaïre	60	124	179	266	329	
Kivu	82	187	287	469	417	
Shaba	305	439	812	1,537	1,458	
Kasaï Or.	76	102	160	192	224	
Kasaï Occ.	44	64	122	229	157	

SOURCE: Banque du Zaïre

Source: IBRD, SAR, SMALL ENTERPRISE DEVELOPMENT PROJECT (1987) p.74

Zaire Annex
Table 5

Capitalization of Commercial Banks in Zaire
(in Z millions)

	Assets	Capital	Capital/Assets
BCZ	10.466	25	0.0024
BDP	5.561	281.3	0.0506
UZB	3.515	30	0.0085
Citibank	1.932	0.25	0.0001
Grindlays	1.125	4	0.0036
BIAZ	930	20	0.0215
BACAZ	831	90	0.108
Barclays	543	2.75	0.005

Source: Annual Reports of Banks, 1985. Garson, p 55.

Zaire Annex
Table 6

ZAIRE - Interest Rate Structure, 1979-83
(Percentage; end of period)

	January 1, 1979	March 10, 1980	April 1, 1981	September 12, 1983
Commercial bank deposit rates				
Savings deposits	3.25	3.25	5.0	5.0
Time deposits				
3-6 months	5.0	5.0	8.0	8.0
6-12 months	10.0	15.0	20.0	20.0
12-24 months	15.0	25.0	30.0	30.0
over 24 months	18.0	negotiable	negotiable	negotiable
Commercial bank loan rates				
Rediscountable credit				
Short-term				
Loans for production & equipment	7.5	7.5	11.0	negotiable1/
Other	12.0	12.0	negotiable	negotiable
Medium- and long-term				
Loans for equipment in agricultural and agro-industrial activities	9.0	9.0	12.5	negotiable1/
Other	15.0	15.0	negotiable	negotiable
Nonrediscountable credit				
Short-term	18.0	18.0	22.0	negotiable
Medium- and long-term	20.0	20.0	negotiable	negotiable
Refinancing rates				
Rediscount rates				
Basic rate	12.0	12.0	15.0	20.0
Short-term production & equipment	5.0	5.0	9.0	..
Medium- and long-term	7.0	7.0	10.0	..
Treasury bonds	bond yield	bond yield	bond yield	bond yield
Advances to banks2/	12.0	12.0	15.0	20.0
Advances with collateral				
Government securities as collateral	6.0	6.0	10.0	..
Commercial paper as collateral				
Short-term	7.0	7.0	12.0	..
Medium-term	8.0	8.0	13.0	..

1/ Except for loans to the noncoffee agricultural sector which now carry an interest rate of 15 percent.
2/ Advances made in connection with interbank clearing at the Bank of Zaire.

Source: Bank of Zaire.

THE WEFA GROUP

ZAIRE

OCT 13, 1987

MACROECONOMIC VARIABLES

	80	81	82	83	84	85	86
GROSS DOMESTIC PRODUCT, MILL US$	6873.1	4756.2	6222.1	5913.4	2987.5	NA	NA
GDP PER CAPITA, US$	260.3	178.8	227.1	210.0	100.6	NA	NA
EXPORTS, FOB, MILL US$	1632.3	579.3	399.8	1130.6	1003.4	947.4	1089.8
CURRENT ACCT. BAL., MILL US$	-154.0	-424.0	-433.0	-310.0	377.0	NA	NA
TOTAL EXTERNAL DEBT, MILL US$	4288.1	4213.1	4083.0	4379.7	4236.2	4821.0	NA
CONSUMER INFLATION, 1980=100	100.0	134.9	183.8	325.5	495.6	NA	NA
US$/ZAIRES, PERIOD AVERAGE	0.36	0.23	0.17	0.08	0.03	0.02	0.02
POPULATION, MILL.	26.4	26.6	27.4	28.2	29.7	30.4	NA

MONETARY SURVEY

	80	81	82	83	84	85	86
MONEY SUPPLY, M2, MILL. ZAIRES	3184.0	4839.0	8223.0	13545.0	18783.0	24745.0	52821.0
CONSUMER INFLATION, 1980=100	100.0	134.9	183.8	325.5	495.6	NA	NA
WHOLESALE PRICE INDEX,1980=100	NA	NA	NA	NA	NA	NA	NA
DISCOUNT RATE	12.0	12.0	15.0	20.0	20.0	26.0	26.0
COMMERCIAL PRIME RATE	NA	NA	NA	NA	NA	NA	NA
GOVT. BOND YIELD, MEDIUM TERM	NA	NA	NA	NA	NA	NA	NA
DEGREE OF MONETIZATION	0.2	0.2	0.3	0.2	0.2	NA	NA

ZAIRE

CONSOLIDATED BALANCE SHEET OF
COMMERCIAL BANKS
MILLION ZAIRES

ASSETS	80	81	82	83	84	85	86
RESERVES	710.0	1012.0	2399.0	3110.0	6045.0	6724.0	12077.0
FOREIGN ASSETS	512.0	801.0	636.0	3298.0	3019.0	4323.0	7422.0
CLAIMS ON GOVT.	162.0	175.0	174.0	176.0	253.0	286.0	640.0
CLAIMS ON PRIVATE SECTOR	1101.0	1265.0	1790.0	2818.0	4408.0	5473.0	9569.0
LIABILITIES							
DEMAND DEPOSITS	1360.0	1912.0	3681.0	6236.0	8217.0	9927.0	16515.0
TIME AND SAVINGS DEPOSITS	415.0	500.0	763.0	885.0	1241.0	1556.0	2553.0
FOREIGN LIABILITIES	131.0	216.0	289.0	744.0	511.0	1002.0	3093.0
GOVT. DEPOSITS	67.0	82.0	126.0	810.0	400.0	93.0	168.0
CREDIT FROM CENTRAL BANK	128.0	50.0	133.0	573.0	1148.0	2182.0	3730.0
CAPITAL ACCOUNTS	168.0	257.0	385.0	778.0	1406.0	2185.0	4729.0
VALUATION ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
OTHER ITEMS, NET	125.0	-104.0	-448.0	-859.0	683.0	-1415.0	10959.0

BALANCE SHEET OF CENTRAL BANK

ASSETS	80	81	82	83	84	85	86
FOREIGN ASSETS	1066.0	1577.0	1221.0	8253.0	11051.0	13556.0	27522.0
CLAIMS ON GOVT.	2831.0	4662.0	9283.0	12777.0	30073.0	47077.0	75662.0
CLAIMS ON OFFICIAL ENTITIES	NA	NA	111.0	91.0	136.0	171.0	243.0
CLAIMS ON COMM. BANKS	128.0	50.0	133.0	573.0	1148.0	2182.0	3730.0
CLAIMS ON SPECIAL BANKS	NA	NA	NA	NA	NA	NA	NA
LIABILITIES							
RESERVE MONEY	2030.0	3235.0	6207.0	10022.0	15660.0	19999.0	46003.0
OF WHICH							
CURRENCY OUTSIDE BANKS	1255.0	2090.0	3283.0	6141.0	8802.0	12294.0	32880.0
QUASI-MONEY DEPOSITS	59.0	138.0	861.0	2479.0	2362.0	573.0	3315.0
FOREIGN LIABILITIES	1512.0	2927.0	5226.0	29771.0	38917.0	53148.0	100374.0
CAPITAL ACCOUNTS	549.0	666.0	-1315.0	-18645.0	-26746.0	-38132.0	-18696.0
RESCHEDULING ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
VALUATION ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
OTHER ITEMS, NET	-883.0	-1835.0	-1541.0	-2730.0	11790.0	26895.0	23936.0

ZAIRE

GOVERNMENT FINANCE
MILLION ZAIRES

	80	81	82	83	84	85	86
DEFICIT(-)/SURPLUS(+)	-332.0	-2158.0	-3484.0	-1653.0	-3764.0	14151.0	NA
REVENUE	3798.0	4744.0	6179.0	11461.0	26851.0	42719.0	NA
EXPENDITURE	4980.0	8063.0	10646.0	15537.0	37268.0	37578.0	NA
FINANCING							
DOMESTIC	205.0	1435.0	3208.0	2520.0	3372.0	-2087.0	NA
FOREIGN	126.0	722.0	276.0	-867.0	392.0	-12063.0	NA

INTERNATIONAL DEBT
MILL. US$

	80	81	82	83	84	85	86
TOTAL EXTERNAL DEBT, (EDT)							
LONG-TERM DEBT	4288.1	4213.1	4083.0	4379.7	4236.2	4821.0	NA
PUBLIC AND PUBLICALLY GUARANTEED	4288.1	4213.1	4083.0	4379.7	4236.2	4821.0	NA
PRIVATE NONGUARANTEED	0.0	0.0	0.0	0.0	0.0	0.0	0.0
USE OF IMF CREDIT	NA	NA	NA	NA	NA	NA	NA
SHORT-TERM	296.0	332.0	224.0	210.0	244.0	309.0	NA
TOTAL LONG-TERM DEBT							
DEBT OUTSTANDING AND DISBURSED	4288.1	4213.1	4083.0	4379.7	4236.2	4821.0	NA
DISBURSEMENTS	492.2	298.9	174.2	202.6	151.1	148.8	NA
PRINCIPAL REPAYMENTS	167.5	68.7	63.2	90.1	117.1	122.0	NA
NET FLOWS	324.7	230.2	111.0	112.5	34.0	26.8	NA
INTEREST PAYMENTS	197.6	125.8	71.5	95.4	202.0	218.9	NA
NET TRANSFERS	127.1	104.4	39.5	17.1	-168.0	-192.1	NA
TOTAL DEBT SERVICE	365.1	194.5	134.7	185.5	319.1	340.9	NA
PRINCIPAL RATIOS							
TOTAL EXTERNAL DEBT							
EDT/XGS)							
EDT/GNP)							
INTERNATIONAL RESERVES							

340

K. ZAMBIA

1. MACROECONOMIC SURVEY

For several years after independence in 1964, high copper prices sustained the Zambian economy. About 95% of total export revenue, half of government revenue, a third of GDP, and over 15% of formal sector employment were derived from the copper industry. Attempts to diversify the economy were channeled into large-scale industrial ventures. Import substitution policies left the small industrial sector reliant on imported materials and therefore on the availability of foreign exchange. Economic growth was not sustained in the 1970s, especially after 1973. The mining sector faced deteriorating external terms of trade and rising real production costs. The external terms of trade declined by 69% between 1970 and 1981. After adjusting for changes in the terms of trade, real gross domestic income fell by an average annual rate of 3.8% from 1970 to 1981. By 1981, real gross domestic income was 35% below that of 1970 and real GDP per capita in 1981 was 60% below the level of 1965 (ILO).

The economic situation in the 1980s has been dominated by the continued long-term decline in the price of copper and inefficiency of Zambian copper production. With the decline in export revenues, there was a fall in foreign aid. Total external loan and grant commitments fell from U.S. $731.1 million in 1979 to U.S. $156.9 million in 1983. Zambia turned increasingly to foreign borrowing. The medium- and long-term public sector external debt disbursed and outstanding increased from U.S. $622.5 million in 1970 (equal to 62.3% of total exports), to U.S. $2.6 billion in 1983 (264% of total exports). Debt service payments rose from 11% of export earnings in 1975, to 21% in 1979, 40% in 1982, and 59% in 1983. Declining export earnings and capital inflows forced a contraction in imports, which in 1983 was only about 45% of the 1970 volume. Since manufacturing and commercial agricultural activities were dependent on imported intermediate goods, domestic production suffered.

Starting in 1983, the GoZ undertook policy reforms to meet the deteriorating economic situation and reduce the internal and external imbalances. The Kwacha was devalued by 20% and the link between the Kwacha and Special Drawing Rights was terminated. Instead, it was pegged to a basket of currencies of the major trading partners and allowed to float against other currencies. Export incentives were given, most consumer price controls were lifted, and agricultural producer prices were raised. An IMF Standby Arrangement of SDR 225 million for 21 months became effective July 26, 1984. The main provisions of the IMF program, like those of other donors, were to reduce domestic and external imbalances and promote agriculture.

The economic situation was critical by mid-1985, with sluggish economic performance, a critical foreign exchange shortage, poor performance for copper exports, and growing

341

arrears on foreign debt. Real per capita GDP, in 1980 prices, had fallen from U.S. $653 in 1972 to U.S. $346 in 1985. The Government of Zambia instituted more ambitious economic reforms in monetary policy. Stated monetary policy was shifted away from setting aggregate credit ceilings on banks to controlling money supply through the amount of reserve money made available to the economy. Domestic interest rates and foreign exchange rates were to be decontrolled.

On September 3, 1985, the government introduced a daily auction of Treasury Bills. The Treasury Bill market offered short-term bills of up to 90 days maturity with interest rates determined by market forces. The Bank of Zambia and the commercial banks were free to participate in the auction. Companies and members of the public had access to the auctions only through commercial banks. The purpose of using open market operations through the Treasury Bill auction was to give the Bank of Zambia more control over commercial bank reserves and therefore over monetary expansion. It was hoped that the restrictive credit policy would moderate fluctuations in the domestic price and exchange rate levels, and that the use of the Treasury Bill auction would be an effective means of financing the government deficit.

The Treasury Bill rate doubled within two months after the auction was introduced, and put upward pressure on the structure of interest rates. Domestic interest rates had been decontrolled at the same time, and commercial banks were free to set deposit and lending rates. The rapidly rising Treasury Bill rate set the lower bound on lending rates. Banks had the option of investing in T-Bills or of making loans at rates reflecting administrative costs of about 1% plus a profit margin over the alternative Treasury Bill rate. This gave banks about a 6% spread over the average cost of deposits, at a time when deposit rates were also rising rapidly. Real lending rates turned positive, albeit very low, as inflation slowed in 1986, but with fairly high nominal lending rates. The T-Bill rate "stabilized" at about 24%, and the average lending rate rose to about 30%, although some borrowers were paying as high as 33%.

The Zambian authorities introduced a weekly foreign exchange auction in October 1985. The value of the Kwacha depreciated dramatically under the auction system. When the auction first started the rate had been Kw 6-8 to $1. By December 1986 and January 1987 the rate rose to Kw 15-16 to Kw 19 per $1. There are several possible explanations for the rapid fall in the value of the local currency, including: (a) the scarcity of foreign exchange for the auction bid up prices, (b) the government did not control the budget deficit and continued inflationary deficit financing, and (c) inflation pushed down the value of the domestic currency. It appears that the analysis done before the reforms had not allowed for the full fiscal impact of the devaluation and had underestimated the resulting budget deficit.

The foreign exchange auctions were suspended from January 28, 1987 until March 21, 1987, because the government was not willing to continue using the auction to determine the exchange rate. The GoZ seemed to believe that the supply of foreign exchange available for the auction was unstable, while the IMF argued that the demand for foreign exchange was unstable because the government deficit was not under control. When the auction was closed, the exchange rate was fixed at Kw 9 = $1. Controls were reintroduced on interest rates. On February 4, 1987 the Central Bank announced that the Bank of Zambia rate was reduced from 30% to 20%. Commercial banks were allowed a lending range of 5% over the discount rate. This meant a reduction in lending rates from about 35% to about 25%. In addition, the Treasury Bill rate was reduced from 28% to 18%, which interfered with the functioning of the Treasury Bill auction. Inflation was about 50% in 1986 so real interest rates were extremely negative. Bank deposit reserve requirements were adjusted in an attempt to control the money supply. However, this was a weak policy instrument against inflationary deficit financing since the budget deficit was at least 70% of the money supply.

The foreign exchange auction was reactivated on March 28, 1987 with a two-tier structure: the official and private channels. The official rate was pegged to a basket of currencies of the major trading partners. The private channel used a Dutch auction system with the official rate used as a floor for bids and no upper limit for bids. If successful, bidders paid only the marginal or strike rate. There was severe rationing in the private channel, but some of the impact on the economy was deferred because most companies had stockpiled inventories of imported inputs. The two-tier system lasted only five weeks before collapsing. During that period the Kwacha depreciated to 21 to $1. Inflation was estimated to be over 50%.

The reform program was abandoned, or at least interrupted, in early May 1987. There is little information available at this time about new policies. The Kwacha was revalued at Kw 8 to $1. The interest rate structure was lowered. Some price controls were reinstated. These policies may not be sustainable for long.

The economy generally did not improve during the reforms. Per capita income declined an additional 4% to 5% between 1984 and 1986. However, some sectors showed strong performance. While the economy grew only 2% in aggregate, the agricultural sector grew 9%. The manufacturing sector grew by 7.5% in 1985, but only by 0.4% in 1986. The financial sector, i.e. financial institutions and insurance, declined by 3.1% in real terms in 1985, and grew by only 0.7% in real terms in 1986. That sector declined slightly from 3.11% of GDP in 1984 to 2.93% in 1986. Growth rates in mining, construction, and transportation, storage, and communications were negative.

The balance of payments position continued to deteriorate over the period of the reforms. In addition to external debt obligations, copper prices declined 20% and copper production

343

declined 31%. There was a massive debt rescheduling in March 1986, but as the following tables show, even after that rescheduling the debt service obligation was unsustainable.

TABLES

Zambia Real Gross Domestic Product, Growth, and Inflation 1984-6

	1984	1985	1986
GDP (million Kwacha in current prices)		7,049	12,098
GDP (million Kwacha in 1977 prices)	2,011.7	2,041	2,052
Real Growth Rate (%)		1.5	0.5
Inflation Rate (GDP deflator)	approx 18	34.3	53.5

Source: USAID. Country Development Strategy Statement, FY 1989, Table 1, p. 18 and Table 6, p. 23).

Zambia Balance of Payments (in millions of SDRs)

	1983	1984	1985	1986
Current Acct.	208	-227	-319	-405
Overall Balance	-294	-444	-499	-502
As % of exports of goods and services:				
Scheduled Debt Service	56.0	67.7	82.6	110.2
After Rescheduling	46.7	41.9	82.6	63.9
After Relief & Arrears	32.2	30.1	18.2	84.2

Source: USAID. Country Development Strategy Statement, FY 1989, Table 2, p. 19 and Table 4, p. 21.

344

Zambia Central Government Budget (in Mln Kwachas, current prices)

	1983	1984	1985	1986
Revenue & Grants			1,691.8	3,349.3
Total Expenditures			2,897.0	6,340.7
Deficit, including grants				
(Commitment Basis)			1,205.2	2,991.4
(Cash Basis)			738.2	3,097.7
GDP			7,049	12,093
Deficit, including grants, as % of GDP:				
(Commitment Basis)			17.1	24.7
(Cash Basis)			10.5	25.6
Deficit, excluding grants, as % of GDP:				
(Commitment Basis)			19.3	28.9
(Cash Basis)	13.0	7.6	12.7	29.8

Source: USAID.. Country Development Strategy Statement, FY 1989, Table 5, p. 22 and Table 6, p. 23 and p.4.

b. Key Issues

The economic situation, by all assessments, is bleak. Severe external and internal imbalances remain. The foreign debt is now estimated at $5.1 billion and copper still accounts for about 90% of the foreign exchange earnings. The budget deficit and inflation are not under control. The long-term decline in per capita incomes continues.

There has not yet been a systematic analysis of the Zambian experience to determine the effects of the reforms. At this time several problems with the reform program are evident:

1. There were serious problems with policy planning, e.g. not considering the full fiscal impact of the devaluation. This was combined with serious problems in implementation, especially in the agricultural sector.

2. The reforms functioned only from October 1985 to December 1986, and then for a few months intermittently. The public never gained confidence that the policies would be sustained, e.g. the government was intervening in the market so the auction was running in arrears during October and November. The private sector began stockpiling inventories in the expectation that the policy was not sustainable.

345

3. Zambia was unable to get the budget deficit under control and the resulting inflation contributed to the fall in the value of the Kwacha. During 1986 it was estimated that the budget deficit was still 35% of GDP. Much of the deficit was due to consumer subsidies on maize and fertilizers. By December 1986 the government was forced to pass a supplementary budget and borrowed heavily from the Reserve Bank. There was a great deal of liquidity in the economy from domestic credit creation by the Reserve Bank to cover the deficit. This inflationary financing contributed to the depreciation in the foreign exchange auction.

4. There were policy inconsistencies. Even under the reform program, the Reserve Bank had been pushing a de facto interest rate policy. Also, parastatals were evidently backed by full credit facilities of the Central Bank in bidding for foreign exchange in the auction and not subject to financial discipline.

5. The trade regime was not rationalized and the structure of effective protection was never dismantled. Because commercial trade policies were never fully changed, this reduced the beneficial effects of a more realistic exchange rate. For example, relative agricultural prices improved markedly and there was a significant production response but agricultural prices did not increase enough to ever reach a neutral position vis-a-vis other sectors because export restrictions were retained.

The transitional period while new policies are formulated will involve a great deal of uncertainty. Until the future policy course is charted, it will be difficult to evaluate the prospects for financial sector reform.

2. THE FINANCIAL SECTOR

a. Introduction

There are very few details available about the monetary and financial system in Zambia. A sketchy outline is presented below, but it is incomplete.

The ratio of money and quasi-money to GDP dropped from 31.3 in 1975, to 29.6 in 1980 and 28.4 in 1981, and then rose again to 38.1 by 1985. From the national income accounts, financial institutions, insurance, real estate, and business services were about 9.5% of GDP at current market prices from 1979 to 1984. In addition to the Central Bank, the Bank of Zambia, there are nine commercial banks and six specialized parastatal financial institutions.

b. Bank of Zambia

The Bank of Zambia (BOZ) was established as the Central Bank in 1965. It administers national monetary and currency policies

primarily through the use of the discount rate and reserve requirements. It manages the international reserves and administers the foreign exchange controls in cooperation with the commercial banks, except during the period when the foreign exchange auction was functioning. It provides rediscount facilities to the commercial banks, although these are rarely used. It lends to the private sector, especially the mining sector. It is commonly perceived in the donor community that the Bank of Zambia has only weak control over the monetary and financial system, and that its inspection system for commercial banks is weak.

c. Commercial Financial Institutions

There are nine commercial banks. The Zambia National Commercial Bank, Ltd. is government owned, and there seems to be at least part government ownership of IndoSuez Bank. The other banks are foreign subsidiaries. Five of the nine commercial banks have been established since 1980 (see the Appendix to this chapter). There may have been an attempt to establish a private-sector indigenous bank, African Commercial Bank, during 1986, but details are not clear.

At the end of 1985, the largest bank, Zambia National Commercial Bank, had assets of Kw 1,305 million, Standard Chartered had assets of Kw 1,090 million, and Barclays had assets of Kw 1.035 million. These three control 75% of total bank deposits. The next largest bank is BCCI with assets of Kw 532 million. The five new banks range in size from assets of Kw 241 million to Kw 64 million and control about 20% of the deposits.

d. Lending Practices

At the end of 1985, about 50% of bank lending was to the private sector, about 38% to the parastatals, and 12% for statutory requirements. The exception is the Zambia National Commercial Bank, which lends heavily to the public sector and the parastatals. Private-sector lending practices follow the typical pattern for import-substitution economies served by foreign banks. Most credit is short term and used to finance trade.

As of September 1985, 29% of the private sector credit outstanding from the commercial banks was for distribution, followed by 18% for manufacturing, 14% for agriculture, and 14% for mining (Bank of Zambia, "Quarterly Financial and Statistical Review," September 1985, Table 1 (xv) p. 36). More recent data are not available, and it is not known whether the distribution of credit changed under the reform program to reflect changes in relative prices. While there is a perception that commercial bank credit to agriculture did increase somewhat, it is not clear whether this was because of high demand with the good weather, or because the commercial banks were overliquid, or because of a change in relative prices.

347

Commercial lending is usually secured with a charge over assets or by a pledge on receivables. In addition to interest rate charges, there are charges which vary with perceived risk such as commitment fees of 0.025 to 2% per annum.

The commercial banks also provide some hire purchase and leasing facilities. Leasing arrangements are available from Barclays, the Bank of Zambia, Grindlays, and the Industrial Credit Company at rates slightly below the rate charged on overdraft facilites. Hire purchase facilities are available from the Industrial Credit Company, but these are not widely used.

e. Commercial Bank Profitability

There are no data on the profitability of the financial institutions. Banking was evidentially very profitable in the early 1980s. Banks were making profits on letters of credit and reportedly earning significant rents from securing foreign exchange permits for customers. During the early 1980s, the government allocated more import licenses than could be supported by the available foreign exchange. The banks were given block allocation of foreign exchange to allocate among customers. There was a 1/2 to 1 million Kwacha overhang in foreign exchange permits. The rents from the nonmarket allocation of foreign exchange disappeared under the foreign exchange auction.

f. Bank Regulations

The information on financial regulations is very sketchy. The documents examined only mentioned that there are reserve requirements of 30% and overall and sectoral ceilings on loans and advances. It appears that commercial banks are restricted to loan maturities of less than three years. The BOZ raised the interest rate schedule in increasing steps between 1982 and 1985 until the rates were completely decontrolled in September 1985. After September, T-Bill and interest rates almost doubled within a two-month period. Interest rate controls were reintroduced after the reforms were halted in May 1987.

g. NonBank Financial Institutions

The government created the Zambia National Building Society in 1971. By mid-1984, the Building Society had assets of about Kw 180 million (Bank of Zambia, "Quarterly Financial and Statistical Review," September 1985, Table 2 (ii) p. 42). The Society provides mortgages from members' share capital and deposits. The deposit rates seem to have been competitive with commercial banks. Up to Kw 500 in interest income from the Building Society is tax free, which is the same limit set for nontaxable interest income from the commercial banks. As of mid-1984 the National Building Society held about Kw 14 million in time deposits, Kw 18 million in savings shares, and Kw 114 million in other shares.

The National Savings and Credit Bank of Zambia (NSCBZ) provides deposit facilities for small savers through the 150 post office branches. The minimum deposit is Kw 10 and interest earned on savings accounts is tax free. Growth in the deposit base has been slow. The NSCBZ had assets of about Kw 52 million by early 1985 (Bank of Zambia, "Quarterly Financial and Statistical Review," September 1985, Table 2 (i) p. 41). No further details are available.

The Zambia National Provident Fund (ZNPF), established in 1966, provides compulsory social security coverage to all workers and offers voluntary savings facilities. It has assets of about Kw 470 million. Detailed information is not available on how this institution invests members' contributions. The Fund carries government debt and provides public sector credit. Of the new funds invested in 1983, slightly less than half was in loans to the government. Total assets as of March 31, 1984 were Kw 550.5 million.

The Zambia State Insurance Corp. Ltd. was esablished by the government in 1967. The investment portfolio of ZSIC was Kw 346 million by the end of 1984, of which Kw 107 million was invested in property, Kw 87 million was in loans to the government, and Kw 77 million was invested in fixed interest-bearing securities. ZSIC occasionally lends to individuals and does some equity financing, but usually invests in real estate or lends to DBZ or the government. While this corporation reportedly has serious liquidity problems now, it has been an important source of profits for ZIMCO in the past.

h. Parastatal Lending Institutions

There are several specialized parastatal financial institutions under the Zambia Industrial and Mining Corporation (ZIMCO), the apex holding company for all state-controlled enterprises, including the Development Bank of Zambia and the Agricultural Finance Corporation. The Agricultural Finance Corporation is discussed in the section on agricultural credit.

The Development Bank of Zambia was organized in December 1972 and started operations in January 1974. Its purpose is to mobilize term resources of up to 15 years, including some on-lending of World Bank and IFC funds, for project finance. Foreign exchange risk is passed on to the borrowers. DBZ has also gotten concessional loans from the Zambia State Insurance Corp. and the Provident Fund. Private sector projects in agriculture, manufacturing, and transport have been funded with loans averaging three to eight years. DBZ has over 300 loans outstanding and does limited (about Kw 4 million) equity financing. Of the loans outstanding, about 70% goes to manufacturing, including agro-industries, 17% to agriculture, and less than 7% to mining. DBZ is also an important source of loans for the government and helps to raise funds for parastatals. With the exception of a small office in the Northwestern Province, the DBZ is based in Lusaka. DBZ has no statutory limit on interest

rates but generally stays close to the lending rate of the commercial banks and there is a 2% to 3% commitment fee. The cost spread is 3% to 4%. At the time it was founded, DBZ had initial authorized share capital of Kw 10 million consisting of 600 "Class A" shares, reserved for the government and its agencies, and 400 "Class B" shares of Kw 10,000 each, reserved for private local and international banks or institutions. DBZ has increased equity with contributions from several European Development Banks. As of March 31, 1986, the total paid-up capital was Kw 18,950,000.

Under pressure from donors, DBZ engaged in an active campaign to collect arrears over the past several years and its portfolio is considered sound. However, the proposed World Bank loan for DBZ has been stalled by macroeconomic policy uncertainty. DBZ has resorted to borrowing short term from the commercial banks which may lead to problems since most lending is for over three

There have been several new small parastatal financial institutions started in recent years but very little information was available about these institutions. The Villages Industries Services (VIS) was formed in 1978 and the Small Industries Development Promotion (SIDO) was formed in 1982. (From the documents reviewed, it looks like SIDO provides extension services and VIS provides financing. No further details are available.) There is also the Small Scale Enterprise Promotion (SSEP) established in 1983 by a joint effort of the Development Bank of Zambia and the Freidrich-Ebert Foundation of West Germany. SSEP provides equity capital and technical assistance to small enterprises.

i. Money and Capital Markets

The money and capital markets are very underdeveloped. The only instruments on money and capital markets are Treasury Bills and local registered stocks. There is no organized stock market. These instruments are held mainly by financial institutions such as the National Savings and Credit Bank of Zambia and the Zambia National Provident Fund. Government finance from the commercial banks seems to depend on Treasury Bills rather than government securities. As a first step toward developing a capital market, the government will need to expand the range of instruments used to finance the deficit.

j. Weakness of the Financial Sector

There is too little information available to analyze the commercial financial institutions. The problems that can be cited are the common problems in many African financial systems: the commercial finance institutions serve only a small segment of the formal economy, credit is overwhelmingly short term, and lending decisions are based on the value of the collateral.

3. COMPLEMENTARY FINANCIAL INSTITUTIONS AND SYSTEMS

a. Informal Credit Markets

Unemployment and underemployment is very high in Zambia. From 1980 to 1986, formal sector employment declined at an annual rate of 1.3%, and it is estimated that less than 17% of the labor force had formal sector employment in 1986. It is estimated that 26% of the population is either unemployed or employed in the informal sector (CDSS, 1987, p. 8). Only a fraction of the population has wage income to support a credit application. There is little information about informal credit markets in Zambia, however, and reports of an informal kerb market may just be internal to the Asian community.

It is hard to speculate what the demand for credit from the informal sector might look like. There is little evidence on how that sector is currently financed. As part of the survey of small-scale enterprises reported by Milimo and Fisseha, there was an effort to extract information about constraints to small-scale enterprises. Shortages of imported raw materials, such as nails, glue, screws, paint, etc, were reported to be the main problem by a large majority of the respondents. Transportation was the second more frequently reported problem. Finance was mentioned as a problem by only 7% of the respondents (Milimo and Fisseha, 1986, pp. 61-62). A credit constraint is usually evidenced only after the major allocation and distribution problems in the informal sector are overcome. It may be that in Zambia other problems remain far more important than lack of access to credit.

b. Rural Financial Markets

The structure of rural financial markets suggests that access to credit must be limited and that there is likely a liquidity shortage in rural areas. The activities of the formal financial institutions, both commercial and parastatal, are concentrated in the richer regions and among commercial farmers. The parastatal agricultural lending institutions have very low repayment performance, suffer periodic liquidity shortages, and are in flux. There is limited credit available for smaller farmers from the cooperatives. There is also reportedly some informal sector credit available from private traders in rural areas, but interest rates are believed to be high, informal loans are small, and repayable at harvest time. Besides the obvious policy-induced distortions in the agricultural sector from the parastatal marketing system, marketing subsidies, and pan-territorial pricing, the lack of a functioning land market is going to make it difficult to develop rural financial markets.

The previous development policy bias against the agricultural sector can partially explain the undeveloped rural financial markets, as can the poor performance of the parastatal agricultural credit institutions. Also it does appear that rural liquidity in general is low, partly because of the rapid urbanization of the population. Unlike many neighboring

countries, urban to rural remittances do not seem to be a significant source of rural liquidity in Zambia. Surveys of rural incomes have not found a substantial remittance flow. Elliott posited that an explanation was that remittances are largely to preserve the remitter's status, rights, and reciprocal obligations to the village which is only important if one expects to return to the village. While it is true that many older men and women do still retire to the village, it becomes a less common expectation as the nature of urbanization changes (Elliott, 1983, p. 184).

Commercial bank involvement in the traditional sector of the economy is limited by the property rights arrangements. Most land is still held in some form of communal tenure system. Producers operating under this system do not have land titles. A small proportion of land is held for 99-year leases under leasehold titles. These leases cannot be transferred to another producer through sale or inheritance, and therefore cannot be used for loan collateral. Land held on leasehold pays a uniform low rental rate of 8 ngwee per hectare. The "land without value" concept with the uniform rental rate does not reflect any improvements or scarcity cost. This reduces the incentive for clearing new lands or improving land with fixed capital investments. Also, the land cannot be used as collateral. This makes lending costs very high in the traditional and informal sectors.

c. Agricultural Credit

Several of the finance parastatals lend to agriculture, including the Development Bank of Zambia (DBZ), and there have been several generations of specialized agricultural lending parastatals, each of which failed and was replaced with a new parastatal. Since the new parastatals were forced to assume the troubled portfolio of its predecessor and fell quickly into the pattern of low repayment, the agricultural credit parastatals have been a continuing drain on the budget. At the current time the Agricultural Finance Corporation (AFC) is to be merged with the newer Zambian Agricultural Development Bank (ZADB) to form a new Lima Bank. There is also some agricultural credit available through the Zambia Cooperative Federation (ZCF).

The AFC provides short-term seasonal production credit with some medium-term and land purchase loans. Of the total loans of Kw 160 million outstanding to AFC at the end of 1984, 71% was for seasonal loans.

There is strong bias in AFC credit distribution to more agriculturally developed areas. Approximately 30% of the population lives in Luapula, Northern, Western and North-Western provinces (ILO, 1981), yet these predominantly subsistence farming areas received only 3.4% of all AFC credit distributed in 1970-79 (IFAD, 1982). This pattern had not changed much since the 1970s. In 1974-75, 96% of all agricultural loans from AFC and the commercial banks went to the three agriculturally most

358

developed provinces. Within those areas, the vast majority of credit went to small-scale commercial producers rather than poorer households. The poorer households did not have the political power to via for the fruits of political patronage (Elliott, 1983, p. 170).

AFC has had severe administrative problems and loan recovery has been low. In 1983, loan recovery was below 50%. By March 1985, AFC had losses of Kw 95.7 million with share capital of only Kw 43.5 million. The Agricultural Development Bank was started to assume the role of AFC.

ZADB started operations in 1983 to provide credit facilities for agriculture, fishing, and agro-industries. Credit facilities are supervised and incorporate technical advise. ZADB, unlike the previous agricultural lending institutions, plans to take deposits. At the time it was conceived, authorized capital was set at Kw 75 million with the government to provide 51%, other institutions 19%, and international institutions 30%. At the end of 1985, subscriptions consisted of Kw 8 million from the government and 0.5 million from the Zambian State Insurance Corporation (ZSIC)

The interest [illegible] structure for ZADB is set by the Bank of Zambia. At the [illegible] 1984 the lending rate was 14.5% for short-term loans and 17.5% for medium- and long-term loans. It is not known if the interest rates for ZADB were decontrolled during the Treasury Bill auction. In the near future, AFC and ADC are to be merged to form the Lima Bank.

The Zambian Cooperative Federation/Financial Services (ZCF/FS) operates a small-scale farmer credit scheme. This credit program has been very small with only about Kw 4 million available. The cooperatives can legally borrow from local commercial banks, and some did so in recent years for seasonal liquidity with a guarantee from the Ministry of Finance. This became a problem when NAMBoard could not purchase the maize and the cooperatives could not repay the loans.

d. <u>Key Agricultural Finance Issues</u>

There has not been any systematic analysis yet of the relationship between liberalization in the agricultural sector and financial policy reforms. There needs to be an evaluation of the effects of price changes, including interest rates, and changing agricultural export and import relations resulting from the foreign exchange auction system, on the agricultural resource allocation process. (For example, commercial farmers took advantage of the depreciating kwacha to increase horticultural exports by 100% in 1985/86.) The rapid depreciation of the currency under the auction added some uncertainty in planning the removal of agricultural subsidies. Clearly, the price and usage level of inputs affects the level of imports, exports, and production, and has an interative effect on other financial variables affected by financial sector reform.

The needed restructuring in the agricultural sector has only been slightly affected by the privatization of marketing channels and the increase in producer prices. There will need to be substantial adjustments to get rid of panterritorial pricing and establish a market price for land. If the liberalization program is resumed, the demand for short-term production credit may be especially high during the transition period of removing subsidies, depending on the timing of reforms. For example, fertilizer must be purchased at the beginning of the season, but producers only receive the new higher level of producer prices several months later. During this lag, there is a need for production credit. (There has also been a need for credit created because NAMBoard has been slow to pay producers.) In addition there will be a need for credit to ease the rationalization of production patterns and to develop new land.

4. CONCLUSIONS

There is very little information available about the financial system in Zambia within the donor community. The donors have been watching developments in the policy reforms, such as the foreign exchange and the Treasury Bill auctions, but have paid much less attention to the market structure and operating practices of the established financial system. Until a new reform program is undertaken, it is highly unlikely that there will be an active attempt by the donors to gather "ground level" information in Zambia. Unfortunately the current uncertainty about the direction of policy has postponed some research activities. The World Bank has postponed the previously scheduled financial sector survey for at least three years.

There is not enough information available at this time to recommend which financial sector activities or studies would be helpful. However, it seems likely that Zambia will be undertaking some form of stabilization cum liberalization program again soon since the present status quo is not sustainable. There will be a need for information about market reaction to the last attempted reforms. A study should be undertaken as soon as possible to assess the performance of the financial institutions under the attempted reform program from 1985-87. The study should investigate whether the financial institutions accommodated the policy changes by changing the allocation of credit. If not, it needs to be determined what signals were the financial institutions responding to. This study should be done as soon as possible. The needed information will not be reflected in changing financial aggregates.

Appendix K.1: Commercial Banks in Zambia

Bank of Credit and Commerce (Zambia), Ltd.
Bank of India
Barclays Bank of Zambia, Ltd.
Citibank of Zambia, Ltd.
Commercial Bank of Zambia Ltd. (60% government-owned)
Grindlays Bank (International) Zambia, Ltd.
Indo-Suez Bank (Another source lists this as Indo-Zambia Bank.)
Meridien
Standard Chartered Bank of Zambia, Ltd.
Zambia National Commercial Bank, Ltd. (Government-owned, established 1969)
Equator Bank (Established 1984. Equator offers credit and advisory services to the government of Zambia and merchant banking services to the private sector, but is not licensed as a bank in Zambia.)

Nonbank Financial Institutions

National Savings and Credit Bank of Zambia (NSCBZ)
Zambia National Building Society (ZNBS)
Zambia National Provident Fund (ZNPF)

BIBLIOGRAPHY

a. Books and Monographs

Bank of Zambia. Ten Years of Banking in Zambia. Lusaka: Associated Printers, undated.

Bank of Zambia. Quarterly Financial and Statistical Review, Vol. 17, No. 3, Sept. 1985.

Economic Intelligence Unit, Quarterly Economic Reviews.
The Economist. "Zambia's Failure." May 9, 1987

Elliott, C.M. (ed.) Constraints on the Economic Development of Zambia. Nairobi: OUP, 1971.

_____, "Equity and Growth: an Unresolved Conflict in Zambian Rural Development Policy." in Ghai, Dharam and Samir Radwan (eds.) Agrarian Policies and Rural Poverty in Africa. Geneva: International Labour Office, 1983, pp. 155-190.

Good, Kenneth, "Systemic Agricultural Mismanagement: the 1985 'Bumper' Harvest in Zambia." The Journal of Modern African Studies, Vol. 24, No. 1, June 1986, pp. 257-284.

Harvey, Charles. "The Control of Credit in Zambia." Journal of Modern African Studies, 1973.

_____, Macroeconomics for Africa: the Elementary

Theory of the Working of Present-Day African Economies, Illustrated by Examples Taken Mainly from the Economy of Zambia. London: Heinemann, 1977.

Milimo, John T. and Yacob Fisseha, "Rural Small Scale Enterprises in Zambia: Results of a 1985 County-Wide Survey." Michigan State University International Development Working Paper, No. 28, 1986.

Pletcher, James R., "The Political Uses of Agricultural Markets in Zambia." The Journal of Modern African Studies, Vol. 24 No. 4, Dec. 1986, pp. 603-617.

Republic of Zambia, Monthly Digest of Statistics, Central Statistical Office. (contains monetary, interest rate, and financial institution data.)

Roberts, R.A.J., "The Role of Money in the Development of Farming in the Mumbwa and Kabete Areas of Zambia." A.I.D. Spring Review of Small Farmer Credit, Vol. 6, Feb. 1973.

b. Project Appraisal and Donor Documents

Deloitte, Haskins, and Sells. "Doing Business in Zambia: A Practical Guide to the Establishment and Conduct of Business in Zambia."

Devres, Inc, "Enhancing Industrialization in Zambia," Aug. 1979.

IFAD, Report of the Special Programming Mission to Zambia, 1982.

ILO, Zambia: Basic Needs in an Economy under Pressure, JASPA, United Printers, 1981. (the first ILO study was in 1977)

Nathan, Robert R. Associates Inc., Development Alternatives, Inc. and Bureau for Africa, Office of Development Planning, U.S. Agency for International Development. "Zambian Agricultural Sector Policy Impact Assessment." March 1987.

USAID. "Zambia Multi-Channel Agricultural Marketing Program (Zamcam)." May 30, 1985.

USAID. "Zambia, Country Development Strategy Statement FY 1985.", Lusaka, Feb. 1983.

USAID. "Zambia, Country Development Strategy Statement FY 1989." Lusaka, April 1987.

World Bank. "Report and Recommendation of the President of the IDA to the Executive Directors on a Proposed Credit of SDR 42.6 million to the Republic of Zambia for a Recovery Program." May 27, 1986. (Report No. P-4310-ZA)...

World Bank. " Zambia: Country Economic Memorandum." (Report No. 6355-ZA), Nov. 19, 1986.

World Bank. "Zambia: Policy Framework Paper." Dec. 9, 1986.

Zambia's Money Supply, 1980-1986
(Kwacha Millions, Current Prices)

Period Year	Period Qtr	Non-Bank Currency	Demand Deposits	M1	Time Deposits	M2	Non-Bank Currency	Demand Deposits	M1	Time Deposits
		Kwacha Million					As a Percent of M2			
1980	4	--	--	519.0	388.1	907.1	--	--	57.2%	42.8%
1981	4	--	--	563.7	415.1	978.8	--	--	57.6%	42.4%
1982	4	--	--	689.5	619.8	1,309.3	--	--	52.7%	47.3%
1983	4	--	--	795.3	658.9	1,454.2	--	--	54.7%	45.3%
1984	1	228.4	457.7	686.1	697.6	1,383.7	16.5%	33.1%	49.6%	50.4%
	2	242.9	489.9	732.8	750.7	1,483.5	16.4%	33.0%	49.4%	50.6%
	3	263.5	626.8	890.3	747.2	1,637.5	16.1%	38.3%	54.4%	45.6%
	4	285.6	581.2	866.8	836.6	1,703.4	16.8%	34.1%	50.9%	49.1%
1985	1	259.3	598.5	857.8	823.0	1,680.8	15.4%	35.6%	51.0%	49.0%
	2	284.0	657.6	941.6	789.0	1,730.6	16.4%	38.0%	54.4%	45.6%
	3	307.6	727.1	1,034.7	835.9	1,870.6	16.4%	38.9%	55.3%	44.7%
	4	343.5	886.2	1,229.7	875.1	2,104.8	16.3%	42.1%	58.4%	41.6%
1986	1	337.3	1,117.4	1,454.7	1,049.7	2,504.4	13.5%	44.6%	58.1%	41.9%
	2	348.8	1,192.4	1,541.2	1,171.3	2,712.5	12.9%	44.0%	56.8%	43.2%
	3	495.4	1,389.8	1,885.2	1,299.3	3,184.5	15.6%	43.6%	59.2%	40.8%
	Oct.	564.0	1,398.5	1,962.5	1,490.2	3,452.7	16.3%	40.5%	56.8%	43.2%
	4	USAID Estimates		2,102.8	1,497.2	3,600.0	--	--	58.4%	41.6%

SOURCE: GRZ, NCDP, Economic Review 1986 and Annual Plan 1987. January, 1987.

Zambia's Money Supply, 1981-1986
(Percentage Changes)

Period Year	Period Qtr	Non-Bank Currency	Demand Deposits	M1	Time Deposits	M2
Year-on-Year Percentage Changes:						
1981	4	--	--	8.3%	6.7%	7.6%
1982	4	--	--	20.1%	40.1%	29.1%
1983	4	--	--	14.3%	6.1%	10.5%
1984	4	--	--	8.6%	23.9%	15.8%
1985	1	12.7%	26.8%	22.3%	16.5%	19.5%
	2	15.6%	29.4%	25.1%	5.0%	15.4%
	3	15.5%	14.8%	15.0%	11.2%	13.3%
	4	18.5%	42.2%	35.0%	4.5%	21.2%
1986	1	26.3%	62.4%	52.8%	24.3%	39.9%
	2	20.6%	59.5%	49.3%	39.5%	44.9%
	3	47.7%	64.8%	60.0%	44.1%	53.2%
	4	USAID Estimates		53.6%	53.7%	53.7%
Annualized Quarter to Quarter Percentage Changes:						
1984	2	24.6%	27.2%	26.3%	29.3%	27.9%
	3	32.6%	98.6%	77.9%	-1.9%	39.5%
	4	32.2%	-30.2%	-10.7%	45.2%	15.8%
1985	1	-38.6%	11.7%	-4.2%	-6.6%	-5.3%
	2	36.4%	37.7%	37.3%	-16.9%	11.7%
	3	31.9%	40.2%	37.7%	23.1%	31.1%
	4	44.2%	79.2%	69.1%	18.3%	47.2%
1986	1	-7.3%	92.7%	67.2%	72.8%	69.5%
	2	13.4%	26.0%	23.1%	43.8%	31.9%
	3	140.3%	61.3%	80.6%	41.5%	64.2%
	Oct.	155.6%	7.5%	48.2%	164.5%	97.0%
	4	USAID Estimates		43.7%	56.7%	49.1%

SOURCE: GRZ, NCDP, Economic Review 1986 and Annual Plan 1987. January, 1987.

THE WEFA GROUP

ZAMBIA

OCT 13, 1987

MACROECONOMIC VARIABLES

	80	81	82	83	84	85	86
GROSS DOMESTIC PRODUCT, MILL US$	3982.7	4182.5	3954.8	3345.0	2958.6	2532.8	NA
GDP PER CAPITA, US$	686.7	721.1	659.1	539.5	455.2	378.0	NA
EXPORTS, FOB, MILL US$	1298.0	1078.5	1023.8	835.5	678.0	1572.2	NA
CURRENT ACCT. BAL., MILL. US$	-537.0	-742.0	-614.0	-228.0	-175.0	-98.0	NA
TOTAL EXTERNAL DEBT, MILL US$	2268.7	2277.9	2419.9	2640.8	2835.9	3214.0	NA
CONSUMER INFLATION, 1980=100	100.0	114.0	128.2	153.4	184.1	253.0	NA
US$/KWACHA, PERIOD AVERAGE	1.27	1.15	1.08	0.80	0.56	0.37	0.14
POPULATION, MILL.	5.8	5.8	6.0	6.2	6.5	6.7	NA

MONETARY SURVEY

	80	81	82	83	84	85	86
MONEY SUPPLY, M2, MILL. KWACHA	907.1	978.8	1309.3	1454.2	1703.8	2101.8	NA
CONSUMER INFLATION, 1980=100	100.0	114.0	128.2	153.4	184.1	253.0	NA
WHOLESALE PRICE INDEX,1980=100	100.0	105.3	112.3	139.3	178.3	262.5	NA
DISCOUNT RATE	6.5	7.5	7.5	10.0	14.5	25.0	30.0
COMMERCIAL PRIME RATE	NA	NA	NA	NA	NA	NA	NA
GOVT. BOND YIELD, MEDIUM TERM	NA	NA	NA	NA	NA	NA	NA
DEGREE OF MONETIZATION	0.3	0.3	0.4	0.3	0.3	0.3	NA

359

ZAMBIA

CONSOLIDATED BALANCE SHEET OF
COMMERCIAL BANKS
MILLION KWACHA

	80	81	82	83	84	85	86
ASSETS							
RESERVES	127.9	139.1	159.7	195.7	275.8	370.2	989.4
FOREIGN ASSETS	45.1	82.7	30.7	56.9	64.5	274.7	771.0
CLAIMS ON GOVT.	275.1	123.6	352.7	310.6	430.8	787.7	1396.5
CLAIMS ON PRIVATE SECTOR	446.8	711.4	759.7	886.5	1054.6	1190.3	1787.9
LIABILITIES							
DEMAND DEPOSITS	358.3	371.3	472.7	547.7	581.5	886.2	1707.6
TIME AND SAVINGS DEPOSITS	388.1	415.1	619.8	658.9	833.9	870.4	1758.0
FOREIGN LIABILITIES	62.5	57.2	100.6	70.0	120.1	515.9	560.8
GOVT. DEPOSITS	32.5	21.0	25.4	30.6	38.0	56.2	134.5
CREDIT FROM CENTRAL BANK	NA	NA	NA	NA	NA	NA	NA
CAPITAL ACCOUNTS	NA	NA	NA	NA	NA	NA	NA
VALUATION ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
OTHER ITEMS, NET	53.5	192.3	84.3	141.6	252.6	294.2	783.8

BALANCE SHEET OF CENTRAL BANK

	80	81	82	83	84	85	86
ASSETS							
FOREIGN ASSETS	71.2	53.2	129.9	174.0	123.2	1145.7	NA
CLAIMS ON GOVT.	1182.8	1393.9	1656.5	2008.6	2418.9	5327.5	NA
CLAIMS ON OFFICIAL ENTITIES	NA	NA	NA	NA	NA	NA	NA
CLAIMS ON COMM. BANKS	NA	NA	NA	NA	NA	NA	NA
CLAIMS ON SPECIAL BANKS	NA	NA	NA	NA	NA	NA	NA
LIABILITIES							
RESERVE MONEY	287.2	334.5	386.7	440.7	518.5	634.4	NA
OF WHICH							
CURRENCY OUTSIDE BANKS	151.1	190.1	209.5	238.8	285.6	342.5	NA
QUASI-MONEY DEPOSITS	NA	NA	NA	NA	NA	NA	NA
FOREIGN LIABILITIES	882.2	1235.1	1506.9	2130.0	2741.4	7514.6	NA
CAPITAL ACCOUNTS	NA	NA	NA	NA	NA	NA	NA
RESCHEDULING ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
VALUATION ADJUSTMENTS	NA	NA	NA	NA	NA	NA	NA
OTHER ITEMS, NET	144.2	-61.9	52.6	-224.1	-552.8	-1523.4	NA

ZAMBIA

GOVERNMENT FINANCE
MILLION KWACHA

	80	81	82	83	84	85	86
DEFICIT(-)/SURPLUS(+)	-567.5	-449.6	-668.2	-307.0	-320.3	NA	NA
REVENUE	765.1	807.1	831.3	1013.4	1090.4	NA	NA
EXPENDITURE	1135.2	1277.7	1400.5	1330.1	1379.4	NA	NA
FINANCING							
DOMESTIC	NA	160.6	531.6	212.1	282.5	NA	NA
FOREIGN	269.6	247.4	111.6	97.5	37.8	NA	NA

INTERNATIONAL DEBT
MILL. US$

	80	81	82	83	84	85	86
TOTAL EXTERNAL DEBT, (EDT)							
LONG-TERM DEBT	2268.7	2277.9	2419.9	2640.8	2835.9	3214.0	NA
PUBLIC AND PUBLICALLY GUARANTEED	2182.0	2227.9	2376.4	2616.0	2812.5	3214.0	NA
PRIVATE NONGUARANTEED	86.7	50.0	43.5	24.8	23.4	0.0	NA
USE OF IMF CREDIT	393.2	730.7	634.9	665.6	697.9	761.6	NA
SHORT-TERM	580.0	581.0	586.0	429.0	388.0	507.0	NA
TOTAL LONG-TERM DEBT							
DEBT OUTSTANDING AND DISBURSED	2268.7	2277.9	2419.9	2640.8	2835.9	3214.0	NA
DISBURSEMENTS	630.9	407.2	348.0	178.5	267.8	262.7	NA
PRINCIPAL REPAYMENTS	187.3	199.1	90.4	47.8	56.2	44.3	NA
NET FLOWS	443.6	208.1	257.6	130.7	211.6	218.4	NA
INTEREST PAYMENTS	106.9	94.2	83.8	74.8	61.1	42.1	NA
NET TRANSFERS	336.7	113.9	173.8	55.9	150.5	176.3	NA
TOTAL DEBT SERVICE	294.2	293.3	174.2	122.6	117.3	86.4	NA
PRINCIPAL RATIOS							
TOTAL EXTERNAL DEBT							
EDT/XGS)	199.6	306.9	338.2	364.7	403.2	529.3	NA
EDT/GNP)	90.2	92.0	100.1	118.7	154.5	210.3	NA
INTERNATIONAL RESERVES	206.1	142.4	157.3	137.3	54.8	201.1	NA

361

CHAPTER 3: THE POTENTIAL FOR FINANCIAL SECTOR REFORM

I. CONCLUSIONS

In this section we examine the issues raised in Chapter 1 in light of the description and empirical evidence provided in Chapter 2. This enables us to determine the extent to which the theoretical premises presented in Chapter 1 are borne out in the cases of the countries in our sample, and also to decide what factors should be included in ranking countries according to the need and prospect for financial sector reform.

Our major observations are in the following areas:

1. Financial Sector Regulations.
2. Macroeconomic Issues and Policy Considerations.
3. Structure and Performance of the Financial Sector.

1. Macroeconomic Issues and Policy Considerations.

A. Chronic imbalances. At the root of the problems plaguing the financial sector in nearly all the sample countries are the chronic imbalances in the fiscal and external accounts. Each country presents a different background to this problem, which we have detailed in our country studies. We are concerned here with how these imbalances have been managed, and the impact they have had on the financial sector.

The persistence of these imbalances has typically affected the financial sector in the following ways:

- Large public sector deficits drain financial resources, leaving limited funds available for the private sector.
- Some banks, particularly those with large government ownership, have been saddled with disproportionate amounts of government and parastatal debt, which has had a major adverse impact on their profitability (e.g. Senegal, Mali, and Niger).
- Large amounts of rediscounting of public sector loans by the Central Bank or outright government borrowing from the Central Bank (e.g. Mali, Zaire etc.) exacerbates inflationary pressures, reducing savings and eroding returns to lenders among other things.
- Persistent current account deficits exacerbate foreign exchange shortages, and often result in a weakening of the currency, contributing to the development of parallel markets in countries where the currency is not fully convertible (e.g. Sudan, Zaire).

302

B. Factors Complicating Savings Mobilization. In most of the countries examined there were factors other than financial regulation inhibiting savings and the financial sector's ability to mobilize resources. These include the following factors, which are almost universally true of all the countries we considered:

- The most obvious factor is the incidence of low per capita income levels, leading to low savings or even dissaving. At the same time, caution must be exercised in dismissing low-income areas (especially rural ones) as having no potential for savings. There is evidence that, due to the low level of monetization, estimates of regional per capita income are inaccurate. This is evidenced by the fact that semiformal institutions (e.g. cooperatives and village associations in Mali) have been successful in mobilizing savings in supposedly very poor areas.

- Lack of confidence in the formal financial sector. This is especially common in countries with high inflation (e.g. Zaire) and in areas (mostly rural ones) where the presence of financial institutions is shadowy at best. The failure (or unwillingness) of the formal financial sector to develop services adapted to the rural environment (e.g. by insisting on high minimum deposit rates and inflexible collateral requirement) is undoubtedly largely responsible for this lack of confidence, which has encouraged the development of informal credit arrangements. The incidence of bank or institutional failures in certain countries (e.g. Kenya, Zaire, Senegal) has tended to further erode confidence.

- The limited variety of financial instruments tailored to the needs and tastes of different savers (e.g. bonds, stocks, CDs, especially in low denominations, etc.) is another problem. The lack of secondary financial markets in all the countries we considered (except Kenya) is another constraint on savings; The lack of competition among financial institutions in many countries (an extreme case being Somalia) results in the persistence of these problems.

C. Receptivity of the Government to Macroeconomic and Financial Sector Reform. Government attitudes toward reform programs advocated by the donor community vary considerably. Some governments (like those of Guinea, Zaire and, until recently, Zambia) have already undertaken far-reaching macroeconomic and financial sector reforms. Other governments (like those of Senegal and Sudan) have been reluctant to adopt major necessary reform measures. In all sample countries, major structural adjustments have only just begun and the agenda of further reforms will require a long-term commitment.

The reforms in question include basic macroeconomic reforms like reducing the budget and current account deficit and rationalizing public sector spending, as well as liberalizing reforms like dismantling price controls, unifying exchange rates, removing barriers to trade, removing restrictions on capital

363

movements, and liberalizing the financial sector. Resistance to basic macroeconomic reforms is usually greater than to financial sector liberalization per se, since the former typically includes cost-cutting measures and structural changes that can affect the balance of political and economic power, and involves a temporary reduction in living standards. All the same, as basic macroeconomic reforms are often a necessary precondition of measures liberalizing the financial sector, financial sector liberalization programs are often derailed because of resistance to the initial stages of a reform program. Worse still, liberalizing the financial sector before liberalizing the current account can be counterproductive, as it will encourage the financial sector to respond to distorted domestic price signals. The sequencing issue should thus be incorporated more emphatically in the design of reform programs, including those focusing on the financial sector.

2. Financial Sector Regulations.

In most of our countries, financial sector efficiency and development are constrained by restrictive financial sector regulations. The commonest forms of restrictive regulations are:

- Interest rate ceilings
- Selective credit controls
- Credit ceilings on individual banks
- Excessive reserve requirements

Nor is this the only problem with financial sector regulations. In many countries the quality of the Central Bank's supervisory functions is weak, thus contributing to the prevalence of unsound practices in the financial sector, and the persistence of regulations which have a detrimental effect on financial development.

A. Interest rate ceilings. In a large number of the countries in our sample interest rates on both deposits and loans that have consistently been subjected to ceilings that have held them at low levels, implying in many instances a negative real return to depositors and institutional lenders, and an implicit subsidy to those able to borrow. Underlying such regulation are the following factors:

- o The government's desire to provide credit at subsidized rates to some sectors of the economy, notably the priority sectors (e.g. agriculture in Kenya, Zaire, and all UMOA countries), and in some cases to the parastatal sector (e.g. Somalia).
- o Lack of adjustment to fluctuations in the inflation rate, in some cases because of constraints stemming from membership in a currency union where interest rate ceilings are uniformly applied (e.g. the UMOA countries).

364

o In the case of the Sudan, which has adopted an Islamic banking code, the inadmissibility of any explicit interest charges.

There is evidence that interest rate ceilings have stymied financial intermediation, encouraged consumption at the expense of investment, and introduced a number of other distortions. There is also reason to believe that, as nonprice credit rationing is inevitable under such circumstances, the allocation criteria for financial sector credit are anything but efficient, being often determined on the basis of established client relationships, political pressures, and other issues such as whether the loan is subject to credit ceilings. In such cases repressive financial sector regulation fosters greater inequality of income distribution.

B. Selective credit controls. Selective credit controls in the form of sectoral lending quotas (e.g. Kenya, Senegal, etc.) or prior authorization requirements (e.g. Zaire and Rwanda) have been justified as a means of insuring that "priority" sectors have access to bank credit. In most instances, however, selective credit controls have failed to fulfill their promise and instead hampered the process of financial intermediation. Examples of problems stemming from such regulation are the following:

- In cases where the Central Bank's ability to enforce regulations is weak, banks are often able to ignore government credit guidelines, at least to some extent (e.g. Sudan). Another common way of evading compliance is the mislabeling of credit uses (e.g. Kenya).
- To the extent that selective credit controls are enforced, banks prefer limit their intake of deposits and restrict total credit rather than extend loans they regard as unprofitable or too risky (e.g. Zaire).
- Forced lending has often led to the weakening of bank portfolios and thus to the undermining of the financial viability of some banks (e.g. Senegal).

C. Credit ceilings applied to individual banks. In nearly all of the sample countries, monetary and credit policy include a global restriction on the growth of domestic credit. However, in a number of countries, the government has distributed available credit to individual banks according to a variety of formulae.

Such practices have had a number of detrimental effects, including the following:

- The allocation of credit to banks facing a liquidity crisis rather than to the banks with sound financial positions (e.g. Senegal).
- Ceilings applied uniformly to all banks, which discriminates against new banks and also against all banks

365

with a greater capacity for lending and more efficient banks (e.g. Mali). This also has the disadvantage of discouraging competition in many areas.

D. Excessive reserve and/or liquidity requirements. In a few of the countries in our sample (e.g. Zaire and Kenya), high reserve requirements, coupled with other restrictions (credit ceilings, funding requirements, etc.) have resulted in the following:

- Higher marginal costs of resource mobilization, which discourage deposit-taking by banks
- Higher cost of credit to borrowers
- Appropriation of reserves to fund government and parastatal deficits, resulting in an inefficient allocation of funds.

E. Quality of Central Bank control. The quality of Central Bank control varies among the countries in our sample, but on the whole it is weak and has not been adequate to detect or prevent financial deterioration and instability in financial institutions. The major factors contributing to ineffective control by the Central Bank include the following:

- Central Bank personnel are often not very experienced and have had limited training (this is almost universal).
- The legislation and regulation governing the financial sector is both complex, in some cases confusing, and often not well-developed, making for difficulty in implementing and monitoring (an extreme example is Sudan).
- The Central Bank is insufficiently independent of the government, and therefore cannot serve as an effective check on public financial institutions in particular (e.g. Somalia, Zaire, etc.)

3. Structure of Financial Sector and Performance of Financial Sector Institutions

A. Public Sector Domination of the Banking Sector. The countries in our sample are characterized by varying degrees of state ownership or government control of the financial sector. In extreme cases like Somalia this control is total; in most countries the government has a major interest in several key financial institutions, and thus exercises substantial control over credit allocation. In other countries the government is trying to increase private sector participation in financial institutions (e.g. Niger); in Guinea the government has undertaken a major divestment program.

In many cases, government domination has had adverse effects on the performance of the financial sector and on the health of the economy as a whole. This is mainly due to the fact that the government has used its influence to direct substantial amounts of credit to public sector institutions, many of which have had major performance problems (e.g. Senegal's ONCAD debt). Also, to the

366

extent that government domination of the market inhibits competition, this results in low operational efficiency and poor and high-cost services.

B. Specialization in Financial Institutions. In many of our sample countries, governments have created specialized financial institutions in response to perceived market imperfections. The commonest examples are agricultural banks, housing finance, industrial banks, and development banks. In the majority of cases, government is a major shareholder, and in many cases these institutions have, as a result, benefitted from concessionary financing, government and parastatal deposit funds, and considerable operating subsidies.

In general, the performance of the highly specialized institutions has been poor, both because of inherent weaknesses in the institutional framework and because of the undiversified and high risk nature of its portfolio. A number of these specialized institutions have merely served as conduits of public sector or donor community funds to identified target groups. In these cases (e.g. the CNCA in Niger and the AFC in Kenya), the institution exercises little control over borrower selection, proper creditworthiness criteria are not rigorously applied, and disbursement takes precedence over loan followup and collection. In addition, as government-controlled institutions, most of these institutions suffer from shortages of skilled personnel, of proper financial management, and of adequate government supervision.

However, there are some examples of good performance by specialized financial institutions; in most cases these are the internationally supported, broadly framed development banks. Examples of these include BNDA in Mali, SOFIDE in Zaire, and BRD in Rwanda. In large part their relative success is due to good access to badly needed foreign exchange resources, and strong participation of a diverse group of national and foreign directors in management.

C. Sectoral Imbalance. Sectoral imbalance is a very common phenomenon in the countries we examined, and the financial sector is often an instrument in perpetuating or even aggravating it. A common form of sectoral imbalance arises when the tertiary sector (usually commerce and services) is growing rapidly at the expense of the primary sector (usually agriculture or mining). It is also not uncommon for the secondary sector (which is often the manufacturing sector) to experience growing pains despite the promise of high productivity and considerable employment-generation. A skewed distribution of credit in favor, of the tertiary sector is almost always partly to blame.

This situation is almost universal in the countries in our sample. Interestingly, it does not appear to be affected significantly by the degree of government control of the financial sector. Both Somalia, where the financial sector is wholly government controlled, and Guinea, where private ownership of the financial sector predominates, suffer from this problem. The

367

theoretical reasons for this bias have been defined in Chapter 1; they include the following:

- The tertiary sector usually has the lowest information costs, reducing inherent risks.
- The trade sector is able to attract considerable credit because of the short-term nature of its financing needs.

Selective credit controls have been the commonest remedy applied by government to these problems. As seen in the section on selective credit controls, the success of this policy measure has been limited.

D. Bias in Favor of Short-Term Lending. In most countries considered in this study, there is a strong bias in favor of short-term lending. This constitutes a bias against productive sectors, which have long startup phases, require long-term financing commitments, and generate profits only in the medium term. This bias toward short-term lending stems from a number of factors, namely:

- The high, unpredictable inflation rate in many countries,
- The difficulty financial institutions encounter in mobilizing term savings or other long-term financing
- Rigidities in interest rate term structures in countries where interest rate ceilings are in effect (e.g. UMOA countries)
- Uncertainty about the future in view of the unstable macroeconomic and financial environments.

E. Lack of Innovations. The incidence of innovations adopted by the formal financial sector in the countries in our sample is low. There have, of course, been important exceptions, among them BNDA in Mali, which succeeded in forging ties with cooperatives and village associations. The explanation for the general lack of innovations can be summarized as follows:

- Tight regulation in many countries leaves little room for innovations.
- Lack of competition among financial institutions in many countries limits the incentive to develop new contractual relationships and services on the part of financial institutions.
- There is a large element of risk in innovations. This runs against the overwhelmingly conservative nature of banking institutions in our sample countries (both state and privately owned banks), stemming largely from the low allowable spreads.
- Innovations usually require a profound understanding of the complex sociological and cultural influences at work in many regions; the small size of the market in each of these regions, and the limited scope of operations of the relatively few branches of financial intermediaries in rural areas, do not make for economies of scale in gathering information about such influences.

368

F. Informal Credit Markets. The status of information about informal credit arrangements in the countries we studied varies considerably. On the whole, however, there is limited information about this important sector.

A number of general statements can be made about the informal sector from the little empirical evidence that is available, namely:

- There is a large, vibrant and highly visible informal sector in both rural and urban areas in many of the countries in our sample, Kenya and Rwanda being notable exceptions.
- The size and importance of the informal sector are affected by such factors as the growth of the economy as a whole, the success (or failure) of the formal sector to serve the needs of the informal economy, and the extent to which regulations restricting informal credit arrangements are enforced.
- The informal sector usually provides financing for primary sector activities (e.g. livestock in Somalia and agriculture in Sudan) and also vital financing for consumption needs.

- In many ways, the informal sector is regarded as "efficient"; it makes credit available to segments of the population not served by the formal sector and seems to be able to counter the problem of high information costs through local specialization. Its success can be gauged by the reported low rate of default on informal sector loans.
- On the other hand, the informal sector typically implies many disadvantages for the borrowers. The cost of informal credit is generally quite high, often unjustifiably so given the moderate cost of loan provision to the lender. Credit allocation is also often influenced by arbitrary factors, among them family ties and the geographic proximity of lenders and borrowers.

G. Semi-formal Credit Institutions. Semi-formal credit institutions have become an important factor in the financial systems of a number of countries considered here, among them Mali, Niger, and Zaire. These institutions include cooperatives, village associations, credit unions, etc., which exist in both rural and urban areas.

In most of our sample countries, there are efforts to bring about the following:

- Legalization of cooperatives
- Development of ties between formal financial institutions and semi-formal ones (e.g. Mali).
- Centralization of cooperatives and pooling their resources (e.g. Zaire).

369

The experience to date with these types of measures is not uniform. In some countries (like Mali), it appears that the experiment of BNDA cooperating with cooperatives and village associations has been successful. There is also reason to believe that encouraging the creation of cooperatives and credit unions in some circumstances may help reduce risks and promote more efficient intermediation with lower information costs. In other countries, measures to force greater centralization and regulation seems certain to undermine public confidence in these institutions (e.g. Niger and Zaire).

H. Islamic banking. Islamic banking institutions exist in three countries in our sample: Sudan, where an Islamic banking code has been recently introduced, Senegal and Niger. In one other country we examined, Somalia, plans for an Islamic bank have been studied by the government.

The most important feature of Islamic banking is interest-free deposits and lending. In practice, however, the absence of interest on deposits is compensated for by a considerable array of services available free of charge to depositors. The absence of interest on loans is supposed to compensated for by an equity-participation type of arrangement, or by a fairly sizable fixed administrative charge on some loans.

The main advantages Islamic banking purports to offer to countries that have allowed the setting up of Islamic banks are:

- A banking system that is more acceptable to a certain segment of the population.
- A lending system that increases the stake of the bank in the success of the project to which it allocates credit, since a portion of loans is often made on the basis of equity-participation.
- A lending policy more oriented toward "beneficial" loans and loans to small borrowers in rural and urban areas.

This, at least, is the promise of Islamic banking. In practice, the record of Islamic banking to date in the countries in our sample is rather uncertain. Information on the Islamic banks in Niger and Senegal is sketchy. In Sudan, however, it appears that there is relatively little specialization by Islamic banks in equity-participation loans, while the average size of their loans has increased substantially in the years since they began operating. It must therefore be concluded that Islamic banks have shown little evidence of acting very differently from traditional banks; in Sudan they appear to have a preference for short-term loans to sectors like trade and services.

310

II. DATA AVAILABILITY

A. Data Availability: Rating of the Availability in each Country of the Following Types of Key Financial Sector Data

Data-->	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	Aver.
Guinea	2	3	3	3	3	3	2	3	3	2	2	3	2.67
Kenya	2	2	1	2	2	2	2	2	2*	1	1	1	1.67
Malawi	2	3	1	2	2	2	2	2	2*	1	3	2	2.00
Mali	1	2	1	1	1	2	1	1	2	1	2	3	1.50
Niger	1	1	2	2	1	3	2	2	1	1	2	3	1.75
Rwanda	1	3	1	1	1	2	1	2	3	1	3	1	1.67
Senegal	1	3	2	1	1	3	2	2	3	1	2	3	2.00
Somalia	1	2	2	2	2	3	2	2	3	2	2	3	2.17
Sudan	3	2	2	3	3	3	2	2	3	2	3	3	2.58
Zaire	1	3	1	1	1	3	2	1	3	1	2	3	1.83
Zambia	3	3	1	3	3	3	3	3	3	3	3	3	2.83
Average	1.6	2.5	1.5	1.9	1.8	2.6	1.9	2.0	2.5	1.5	2.3	2.5	2.07

Ratings: 1 = Good data availability.
2 = Fair data availability.
3 = Poor data availability.

Note: (*) Data on the semi-formal is much better (=2) than the data on the informal sector (=0).

Key Data Requirements

1. Data on the structure of deposit and lending interest rates.
2. Information on noninterest and transaction costs (e.g. fees, compensatory balances, and high transportation costs).
3. Data on structure of banking sector liabilities and assets.
4. Data on the sectoral allocation of credit.
5. Data on the use of central bank rediscounting facilities.
6. Information on the quality of bank loan portfolios.
7. Data on individual banking institutions.
8. Data on nonbank financial institutions.
9. Data on the semi-formal (e.g. cooperatives and credit unions) and the informal financial sectors.
10. Detailed information on financial sector regulations.

371

11. Information on central bank monitoring and inspection.
12. Information on equity financing institutions.

B. Country Ranking by Data Availability

1. Mali
2. Kenya
   Rwanda
3. Niger
4. Zaire
5. Malawi
   Senegal
6. Somalia
7. Sudan
8. Guinea
9. Zambia

Notes:
1. On the whole, French-speaking countries appear to have better data availability. UMOA countries are among the highest-rated.
2. Kenya is high-rated as it has one of the most sophisticated banking sectors in Africa.
3. As will be seen presently, the correlation between availability of good data and strength of financial sector is far from perfect. Mali's financial sector, for instance, is hardly strong, and Guinea's is one of the most promising ones.
4. For the countries in our sample as a whole, information on the semi-formal and informal credit sectors, equity financing institutions and on noninterest credit costs is the hardest to find. The easiest to find are data on the structure of the banking sector's liabilities and assets and on the structure on deposit and lending rates, and information on financial sector regulation.

372

III. CRITERIA FOR ASSESSING NEED AND PROSPECTS FOR FINANCIAL SECTOR REFORM

A. Explanation of Criteria

The criteria listed here are intended to enable us to evaluate the comparative need and prospects for financial sector reform in the countries in our sample. While numbers are used to make the evaluation, an element of judgment is introduced in the case of each criterion as we compare each variable to a threshold level and determine the extent to which a country's status is problematic, bearing in mind important caveats about the applicability of each criterion.

The criteria are divided into two groups: (a) those criteria related to the macroeconomic environment, and (b) those criteria related specifically to the financial sector. When discussing the possibility of financial sector reform and the proper sequencing of reforms, the relationship between the macroeconomic and financial sector criteria becomes important.

MACROECONOMIC ENVIRONMENT

1. Recent annual inflation. We consider that high inflation is indicative of a high degree of financial instability, as it indicates lax monetary control and the persistence of destabilizing pressures.

Important caveats:

- The inflation figure must be interpreted cautiously if the cost-push element in inflation is judged to be high, as that does not necessarily suggest recurrent pressures. Indeed, high inflation is often a necessary concomitant of structural adjustment, in which case it is not necessarily indicative of instability.
- It does make a difference whether inflation is accelerating or decelerating. A high inflation rate that represents an improvement over the previous year's level may indicate higher stability than a moderate inflation rate that is higher than the previous year's.
- The GDP deflator is used whenever possible to measure inflation, as the consumer price index has many biases, not least of which being that it is an urban index, and we are dealing with predominantly rural countries. In cases where the GDP deflator is not available and the consumer price index is used this must be taken into consideration.

2. Government budget deficit, as percentage of GDP. The relative size of the government budget deficit is an important indicator of the degree of fiscal responsibility and control exercised by the government. A relatively large budget deficit suggests poor tax collection abilities, a narrow tax base and/or inability to control public spending. The persistence of chronic fiscal

373

imbalance is expected to lead to inflationary pressures and/or an increase in foreign debt.

Important caveat:

- In many countries the degree of fiscal imbalance is understated by the government deficit, as the parastatal sector may also be running a large deficit.

3. Current account deficit, as percentage of GDP. A high current account deficit relative to GDP is indicative of external imbalance; it suggests that the country is unable to meet its needs for foreign goods and services without resorting to foreign borrowing. The usual reasons are: collapse of the price of the major export commodity, production problems related to exportable goods (often a result of inadequate price incentives), excessive import demand, an overvalued currency and/or inability to mobilize the savings of citizens working abroad.

Important caveats:

- Currency overvaluation will tend to distort the ratio, since it will understate the relative importance of the current account deficit (measured in dollars) relative to GDP (measures in national currency units).
- Substantial improvement or deterioration in the current account balance may be recorded due solely to temporary shifts in international prices (including crop failures, force majeure restricting or increasing supply of their major exports or imports). In such cases this ratio may be misleading, as it may imply a situation that will not last much longer.

4. Debt-service ratio (ratio of debt service commitments to export earnings). This is an important indicator of the debt burden. A high debt service ratio is obviously the result of high accumulated indebtedness; it can be made worse by increases in the international interest rate or by the country's failure to win concessions from lenders and/or the donor community.

Important caveats:

- Sometimes the ratio of debt-service commitments to total exports of goods and services rather than goods alone is a better indicator of the real debt burden, as certain countries depend heavily on service exports to generate foreign exchange earnings.
- Transfers (both official and private), which are not captured in the debt-service ratio, often suggest a lighter debt burden than the debt-service ratio seems to indicate.
- Debt relief or forgiveness may temporarily lower the debt-service ratio, but this state of affairs is not indefinitely sustainable.

5. Annual real per capita growth. Lack of growth is a highly

374

problematic situation, especially in underdeveloped economy where the standard of living is low to being with. It is important to adjust for inflation (hence the focus on real growth) and for population growth (hence the focus on per capita growth). If per capita real growth is negative this is an indication that the standard of living is in fact deteriorating rather than improving. Important caveat:

- In nearly all developing countries, the low degree of monetization suggests that the GDP figure underestimates the total level of economic activity. This, and the fact that national income statistics are generally the least reliable in most countries, may dilute the meaning of this index.
- Force majeure (bumper crops, crop failures, civil strife, etc.) may temporarily dampen or boost growth. Thus the recent GDP growth rate(s) may not be indicative of the underlying trend.
- Structural adjustment programs often have a dampening impact on growth. Low growth rates may thus not be a sign of poor performance, but rather of movement toward structural adjustment, which is a positive development.

FINANCIAL SECTOR DATA

1. Extent of public sector ownership of the financial sector. This is an indicator of the extent to which the government exercises direct control over the financial sector. A high degree of government ownership suggests that the financial sector is almost certainly oriented to public sector financing, and has relatively limited independence. Government domination of the financial sector may be high because the government is unwilling to allow the private sector a greater role in commercial banking, because it cannot interest the private sector (including foreign banks) in participating in the domestic banking sector, or both.

2. Public sector share of domestic credit as a percentage of total credit. This an indicator of the extent to which public sector financing crowds out financing for the private sector. A high share (over 50%) is taken to indicate that the public sector's needs overwhelm the country's abilities to mobilize financial resources. Such a situation is regarded as problematic, as it implies that private sector financing needs cannot easily be met by the financial sector, which stymies the growth of the sector, especially of new industrial ventures. It also suggests that credit may be allocated on a suboptimal basis, since profitability criteria are rarely used to evaluate credit allocations to public sector projects. Moreover, to the extent that such debt is often discounted or absorbed by the Central Bank at a later stage, it is often indicative of inflationary potential.

3. Real deposit rates. This is an indicator of the real (average) return savers realize on their bank deposits. A negative real deposit rate is indicative of financial sector repression, as it suggests that ceiling deposit rate (or the deposit rate that the

315

banking system is willing to pay) has fallen short of the inflation rate. This complicates the task of mobilizing savings and limits the scope of financial intermediation.

Important caveats:

- In many countries the inflation rate is difficult to measure accurately; also, the urban inflation rate may differ from the rural inflation rate, suggesting that what is considered a negative deposit rate may not be so in fact.
- The real deposit rate is determined by looking at the most recent rate and subtracting the corresponding actually recorded (ex post) inflation rate from it. To the extent that the inflation rate that would prevail was not in fact known in advance by the bank or the depositor at the time the deposit was made, there is a possibility that their perception of what the real deposit rate would differ from what actually transpired.

4. Real loan rates. Negative real loan rates are considered indicative of financial sector repression. If the ceiling-determined nominal loan rate is lower than inflation, this in effect suggests that all lending represents a subsidy to the borrower, a factor which discourages bank lending, suggests that credit allocation is done on a nonprice basis, and that possibly severe credit rationing is occurring.

Given that data on prime commercial rates and/or on other lending rates are rarely available in the countries studied, the central bank discount rate is substituted as a proxy for --although it is typically several points lower than -- commercial loan rates.

Important caveat:

- The same caveats relating to the inaccuracy of the inflation figure and the difference between expected and ex post inflation mentioned in reference to the deposit rate apply here.
- Loan rate ceilings are not always strictly adhered to.

5. Individual bank credit ceilings. The existence of individual bank credit ceilings is suggestive of financial sector repression. This is not in itself an attack on global credit ceilings, which are often a necessary first step toward restoring stability and fiscal equilibrium. At the same time, the arbitrary allocation of credit quotas by the government stifles competition between banks and (to the extent that quotas are based on the size of current deposits or lending) inhibits the growth of new financial institutions which are often more dynamic. This often penalizes the private sector (especially small-scale entrepreneurs, rural and urban).

Important caveat:

376

- Credit ceilings are not infrequently violated by individual banks in cases where the Central Bank's ability to enforce ceilings is limited.

6. Selective (sectoral) credit control. The existence of sectoral credit controls is usually intended to provide assistance to specific "priority" sectors. In practice, however, they usually do not benefit rural and urban entrepreneurs and investors with new capital ventures significantly, as banks are inhibited by high information costs, the long-term nature of credit needs and the high riskiness of some ventures from filling the credit quotas. As a result what usually arises is financial sector repression; the financial sector simply loses interest in boosting deposits and extending credit in general since it cannot rise to a level consistent with its lending to the disadvantaged sectors.

Important caveat:

- Sectoral credit controls are not infrequently ignored by banks in cases where the Central Bank's ability to enforce controls is limited.

7. Degree of nonperforming loans. The relative importance of nonperforming banks' loan portfolio is an indication of the extent to which the financial sector is in trouble, and the degree to which poor allocation criteria were made by banks in the past.

Important caveat:

- The provision for nonperforming loans is usually arbitrarily determined and often understated.

8. Urban concentration. The extent to which bank branches are concentrated in the capital city. To the extent that bank activities focus on the capital, banks' rural outreach can be assumed to be limited, and hence their familiarity with rural areas and their ability to serve its needs.

Important caveats:

- As the size and importance of individual bank branches differs, there is a danger of misrepresentation if the number of banks in rural areas is the only factor considered.
- In some cases branches outside the capital city are concentrated in other very large cities, which is hardly an indication of greater accessibility to agricultural and rural markets.

9. Quality of commercial bank management. This is a qualitative criterion. It is determined on the basis of a subjective evaluation of commercial bank managers' training, financial integrity, use of profitability criteria, and capacity for innovation.

371

10. Quality of Central Bank controls. This is also a qualitative criterion. It is determined on the basis of a subjective estimate of the extent to which the Central Bank fulfills its supervisory role, its independence of government, and the monetary policy tools at its disposal and its ability to use them.

12. Progress on financial sector reform. This is also subjective to some extent. It is determined on the basis of the government's past record and its official attitude toward financial sector reform, it being understood that there is often a discrepancy between what the government says and what it does. It is important here to take account of the government's overall attitude toward reform, macroeconomic as well as financial sector related, since it is usually impossible to carry out far-reaching financial sector reform without first implementing macroeconomic reforms that lead to a measure of stabilization.

B. THE USE OF THE CRITERIA.

The criteria listed above are intended to help us to evaluate two quite distinct issues:

- To what extent does the country need far-reaching financial sector reform?
- How ready is the country for such reform, and what is the likelihood that it will be implemented successfully and that it will produce the desired results?

Nature of Financial Sector Reforms to Be Introduced

A word must first be said about the nature of the financial sector reform alluded to here. There are various types of reform which have varying relevancy and varying chances of success in different circumstances. These include:

1. Reforms aimed at strengthening existing viable financial institutions, through:

    - o Technical assistance and training programs
    - o Restructuring, cost-cutting and improved streamlining of staff activities and closing nonviable ones
    - o Encouraging improved and more efficient loan appraisal and collection techniques
    - o Improving standards of inspection and supervision by the Central Bank to the extent that such supervision is not used to enforce counterproductive or repressive financial regulation, but rather to monitor soundness.
    - o Improving the legal system in the critical areas of contract law and property rights, to insure that legal codes are unambiguous and that court injunctions are enforceable.

318

2. Reforms aimed at liberalizing the financial sector, such as:

- o Raising or removing interest rate ceilings
- o Relaxing or removing credit controls on particular banks with sound growth potential
- o Recapitalizing (or, if possible, privatizing) troubled financial institutions considered viable
- o Relaxing or removing sectoral credit controls where they are perceived to be counterproductive
- o Increasing competition between financial institutions by at least partially privatizing banking institutions dominated by the government, and phasing out regulation which imposes arbitrary restrictions on the activities of certain financial institutions.

3. Reforms aimed at increasing the physical scope or outreach of the financial system:

- o The creation of new financial institutions, ideally bringing together the domestic and foreign private sectors.
- o The setting up of credit facilities or credit programs to be administered by existing financial institutions which are thereby encouraged to engage in more intermediation and expand to new sectors and geographic areas.
- o Introducing new financial instruments that would form the basis of revitalized financial markets accessible to both financial institutions and individual investors.

These distinction between these reforms is important to bear in mind. The reforms mentioned under (1) are generally the ones most acutely needed, and as such should be among the first to be adopted. The major precondition for their success is the availability of adequate information, for instance about the quality of the management at banks and other financial institutions, the extent and nature of restructuring needed in some financial institutions, the sectoral distribution of bank credit, and the quality of Central Bank controls. They may involve, or be tied to, small-scale assistance from the donor community, and, where applicable, are ideal candidates for the first round of financial sector reforms. Some of these reforms (notably the restructuring of financial institutions) may be conducive to greater fiscal responsibility on the part of the government, and hence to an ultimate improvement in the macroeconomic environment.

The reforms mentioned under (2) essentially entail making the financial system more market oriented. Some of these are potentially destabilizing for both the financial sector and the economy as a whole; some of them may push inefficient or troubled banks to the brink of bankruptcy, or they may do the same to possibly productive borrowers unable to adjust quickly to new conditions in the financial sector (e.g. higher loan rates). As

379

they are far-reaching, it may be difficult to implement them without some skill having been demonstrated by the managers of existing financial institutions, and the prior achievement of at least a degree of macroeconomic stability. Also, attention must be paid to the sequencing of liberalizing reform in the financial sector. As it is intended to bring about a greater degree of adjustment and improved resource allocation, it is important that prior progress be made in liberalizing the current account, to insure that domestic price signals are adjusted to international ones. A logical sequel to financial sector liberalization would be capital account liberalization, allowing the free flow of capital to make domestic users and suppliers of financial resources compete with international ones.

The reform outlined in (3) are reforms which in many cases require a degree of sophistication in the financial system. In particular, they often require the availability of bank managers with proper project evaluation skills and a capacity for initiating innovations, the development of mechanisms for the diffusion of information about investment opportunities, a reliable legal system, and good standards of accounting and auditing. They must also be preceded by a better understanding of rural credit conditions and the potential for mobilizing rural credit, and of the informal sector and its financial needs and problems.

The Need for Financial Sector Reform

To begin with, it must be made clear that there is no country in our sample that is not in need of substantial, far-reaching financial sector reform. The issue is therefore not which countries need reform, but what kind of reform they need, how much of it and how urgently.

The countries whose financial sector is severely repressed, dominated by the public sector, and characterized by poor management and systematic misallocation of resources, are obviously in need of significant reform measures. The timing of such reforms may be problematic, however; on the one hand a financial sector in very poor shape can be said to need reform quickly, on the other hand such a financial sector may not be ready for any but basic reforms. Hence the importance of considering the prospects for financial sector reform in every country, to determine whether a major reform drive, however urgently needed, is likely to succeed.

The Prospects for Financial Sector Reform

The prospects for financial sector reform refer to three related factors:

- How ready is the country for financial sector reform?
- How likely is it that financial sector reform packages will be successfully implemented?
- How likely are financial sector reform packages to bring

380

about the desired results?

The issue of the country's readiness for financial sector reforms must be addressed at two levels:

- Does the macroeconomic environment seem auspicious for the adoption of financial sector reforms, or make such reforms wise at present?
- Is the government disposed to cooperate on financial sector reform, given political and ideological constraints?

The issue of successful implementation is somewhat different. It revolves essentially around the following:

- Are the government and the monetary authorities administratively capable of handling the implementation of financial sector reforms, adjusting their application to evolving conditions, and, in some cases, administering aid disbursements linked to the adoption of these reforms?
- Is the government likely to remain committed to the principle of financial sector reform over a period long enough for a sustainable reform program to be implemented?

The issue of the reforms bringing about the desired results is perhaps the most problematic of all. Even with the best intentions, and with promising initial conditions, external shocks or internal complications could derail any reform program or put pressure on the government to change directions.

A policy dilemma arises here. The risk of failure is highest for countries whose need for financial sector reform is greatest, as the adjustment process is likely to be long and painful in such countries, information vital to the success of reform measures may be sparse or unreliable, and the country's past record in managing its financial sector is not promising. Yet the pressing need for reform in these countries would normally make them top candidates for aid earmarked for financial sector reform. In effect, the donor is asked to select between giving priority to allocating aid to countries with a pressing need for financial sector reforms but a high risk of failure in bringing these reforms to fruition, or to countries with a less obvious need for financial sector reforms but a better chance of success in getting these reforms to work.

C. SUGGESTED APPROACH.

We propose to use the criteria in the following manner:

(1) The ratings indices will be averaged to give us a ranking of the countries according to what the data tell us about their macroeconomic environment and their financial sector. The two ranking systems will be kept separate.

(2) The rankings will be discussed in light of our

381

empirical study of the countries. We shall attempt to evaluate the two rankings and establish their validity as a means of comparing the macroeconomic environments and financial sectors of the countries in our sample.

(3) We shall then discuss how these ranking systems can be translated into guidelines for allocating USAID funds for the support or financing of financial sector reform programs. Recommendations as to the nature of reforms to be considered in countries with different positions in either ranking scheme will be presented.

(4) Ways of deriving alternative ranking schemes to address specific allocative criteria will be outlined.

D. THE RANKING RESULTS.

1. Presentation of the Results.

Criteria for Evaluating the Need and Prospects for Fin. Sector Reform

A.1 MACROECONOMIC ENVIRONMENT, DATA

Criteria -->	Recent Infla- tion (1)	Gov't Deficit (% GDP) (2)	Current Account Deficit (3)	Debt-Service Ratio (4)	Real Per Capita Growth (5)	Current Account Liberl. (6)	Capital Account Liberl. (7)
Guinea (1986)	30.0	18.0	4.3	15.0	1.0	Consid.	Consid.
Kenya	13.1	4.0	3.7		-0.2	Moderate	Moderate
Malawi	17.5	5.9	6.1	20.4	1.0	Moderate	Moderate
Mali (1985)	5.7	1.2	20.1	17.6	9.6	Moderate	Moderate
Niger (1985)	7.5	4.8	7.5	26.7	3.8	Moderate	Moderate
Rwanda (1985)	1.8	1.7	8.4	5.5	-1.2	Moderate	Moderate
Senegal ('85)	12.5	3.5	15.6	29.0	1.0	Moderate	Moderate
Somalia ('85)	37.8	14.3	19.7	44.8	1.5	Moderate	Moderate
Sudan (1985)	45.4	5.2	5.2	15.6	-4.6	Negl.	Negl.
Zaire (1985)	35.0	6.1	4.1	26.7	-2.5	Moderate	Moderate
Zambia (19)	37.4	6.5	4.2	10.2	-4.5	Negl.	Negl.

A.2 MACROECONOMIC ENVIRONMENT, RATINGS

Guinea	2	2	2	2	2	1	1
Kenya	2	2	2	2	2	2	2
Malawi	2	3	2	2	2	2	2
Mali	2	3	3	3	3	2	2
Niger	1	2	3	3	3	2	2
Rwanda	1	2	2	1	2	2	2
Senegal	2	3	3	3	3	2	2
Somalia	3	3	3	3	2	2	2
Sudan	3	2	2	3	3	3	3
Zaire	3	3	3	3	3	2	2
Zambia	3	3	3	3	3	3	3

Ratings: 1 = indicates relative economic stability.
2 = indicates a fair amount of economic instability
3 = indicates a period severe instability

Note: Data are generally from the year indicated, with a few exceptions.

383

Criteria Definitions:

1. Inflation, based on the GDP deflator.
2. Government budget deficit, as % of GDP.
3. Current account deficit, as % of GDP.
4. Debt-service ratio.
5. Annual real per capita growth.
6. Recent progress toward current account liberalization (e.g. the trade regime).
7. Recent progress toward capital account liberalization (e.g. exchange controls on capital flows).

384

Criteria for Evaluating the Need and Prospects for Fin. Sector Reform

B.1 FINANCIAL SECTOR DATA

Criteria-->	Extent of Public Ownership (1)	Publ Sector Share of Domes. Credit (2)	Real Deposit Rates (3)	Real Loan Rates (4)	Individual Bank Credit Ceilings (5)	Sectoral Credit Controls (6)
Guinea	0	Low	-25%	-20%	No	No
Kenya	1/3	Intermed.	+3%	+6%	No	Yes
Malawi	100%	Very high	-5%	+1%	No	No
Mali	High	31%	+0-2.2%	+1.2-7.4%	Yes	Yes
Niger	High	40-45%	Neg.	+1.5-8%	Yes	Yes
Rwanda	High	15%	+4.5%	12.1%	Yes	Yes
Senegal	High	50	-5.8%	Pos.	Yes	Yes
Somalia	100%	69%	-17%	-15%	Yes	Yes
Sudan	50-60%	70%	(-20.6%)	(Neg.)	Yes	Yes
Zaire	High	70%	Pos.	Pos.	Yes	Yes
Zambia	Slight	?	-12.3%	-18.8%	?	?

B.2 FINANCIAL SECTOR, RATINGS

Guinea	1	1	2	2	2	1
Kenya	2	2	2	2	2	3
Malawi	3	3	2	2	2	2
Mali	2	3	2	1	3	3
Niger	3	3	2	1	3	3
Rwanda	2	1	1	1	2	2
Senegal	3	3	3	2	3	2
Somalia	3	3	3	3	3	1
Sudan	2	3	3	3	3	3
Zaire	3	3	1	1	3	2
Zambia	1	?	3	3	?	?

Ratings: 1 = indicates minor problems in the financial sector.
2 = indicates moderate problems.
3 = indicates major problems.

Criteria Definitions:

1. Extent of public sector ownership of the financial sector.
2. The public sector share of total domestic credit.
3. Real deposit rates.
4. Real loan rates.
5. Individual bank credit ceilings.
6. Sectoral credit controls.

385

Criteria for Evaluating the Need and Prospects for Fin. Sector Reform

B.3 ADDITIONAL FINANCIAL SECTOR DATA

Criteria-->	Degree of Non-Perform Loans (7)	Urban Concen-tration (8)	Quality Bank Man-agement (9)	Central Bank Controls (10)	Progress on Finan Sector Reforms (12)
Guinea	Low	High	Mediocre	Weak	Consid.
Kenya	High	Mod.	Fair	Fair	Reasonable
Malawi	High	Mod.	Fair	Mediocre	Poor
Mali	High	Mod.	Poor	Mediocre	Mod.
Niger	13%	Mod.	Poor	Fair	Poor
Rwanda	7%	Mod.	Good	Average	Mod.
Senegal	7%	Mod.	Good	Fair	None
Somalia	High	High	Poor	Poor	Slight
Sudan	Mod.	High	Fair	Poor	Slight
Zaire	Mod.	Mod.	Good	Poor	Some
Zambia	?	Mod.	Good	Poor	None

B.4 FINANCIAL SECTOR, RATINGS

Guinea	1	3	3	2	1
Kenya	3	2	3	3	2
Malawi	2	2	1	2	3
Mali	3	1	2	2	2
Niger	3	2	2	2	3
Rwanda	2	2	1	3	2
Senegal	3	2	2	2	3
Somalia	3	3	3	3	3
Sudan	3	2	2	3	3
Zaire	2	2	1	3	2
Zambia	?	2	1	3	3

Ratings: 1 = indicates minor problems in the financial sector.
2 = indicates moderate problems.
3 = indicates major problems.

Criteria Definitions and Ratings:

7. Percentage of non-performing loans as an indicator of financial sector stability and performance.
8. Urban concentration is an indicator of the outreach of the financial sector to agricultural and rural markets.
9. Quality of commercial bank management. A qualitative criteria.
10. Ability of the central bank to monitor commercial bank safety and soundness.
11. Degree of government progress on previous financial sector reform, as evidenced by related actions and policies.

386

Macroeconomic Environment, Ranking by Perceived Stability and Auspiciousness for Financial Sector Reform.

1. Guinea
   Rwanda
2. Kenya
3. Malawi
4. Niger
5. Mali
   Somalia
   Senegal
6. Sudan
   Zaire
7. Zambia

Ranking by Perceived Strength of the Financial Sector

1. Guinea
   Rwanda
2. Zaire
3. Kenya
   Malawi
   Mali
   Niger
4. Senegal
5. Sudan
6. Somalia

* Zambia

N.B.:

(1) Data on Guinea is highly unreliable. It is almost impossible to draw definite conclusions about the country's macroeconomic environment or about its financial sector in view of the fact that the reform package being implemented there is in its early stages, and conditions could change very quickly. As such we preferred to exclude Guinea from the ranking according to the macroeconomic environment or the financial sector. A number of financial sector and other reforms have been adopted, in name at least; it remains to be seen whether they will be effective or longlasting. Meanwhile the general feeling is that it is too early to contemplate additional far reaching reforms without waiting to see the outcome of the ongoing reform process.

(2) Data on Zambia are so sparse that there are serious gaps filling in the criteria data. As such we felt it would be safer to exclude Zambia from the ranking. The general feeling (which may be subject to change if more data become available) is that Zambia would make a very poor candidate for substantial financial sector reform, because of the unsustainability of the macroeconomic status quo, and the negative attitude to overall reform currently believed to be prevailing.

2. Comments on the ranking schemes:

- In averaging, equal weights were assigned to all the criteria. Subjective arguments could be advanced for a different weighting scheme, but we felt that each of these rated a point in the overall evaluation scheme.
- Comparing the financial sectors of these countries does represent a problem, as their financial systems differ substantially. Many of these differences arise from the different colonial regimes that existed in the past. In at least three countries which were British colonies (Kenya, Malawi and Zambia), the presence of large parastatal institutions (which are barely involved in financial intermediation in the strict sense) set up for the express purpose of financing the public sector is a unique feature. Including these institutions in the ranking scheme is imperative, as they are likely to be the core of any financial sector reform scheme, but they do create problems of comparability. In particular, they relegate Kenya and Malawi to relatively low positions, when the rest of their financial sectors (which is quite comparable with the overall financial sectors of the other countries) is in fact in much better shape. This should be borne in mind. The following is an alternate ranking of countries by their need for financial sector reform in which the parastatal financial institutions of these three countries are regarded as outside the financial sector:

* Zambia

1. Kenya
2. Guinea
   Rwanda
3. Malawi
4. Zaire
5. Mali
   Niger
6. Senegal
7. Sudan
8. Somalia

* Zambia

- The financial sector ranking scheme is used to determine the comparative need for financial sector reform. As such the countries at the top of the list are the ones most in need of reform. However, the ranking system is focusing on the weakness of the financial sector; generally speaking, the weaker the system, the greater the need for reform. But if it becomes necessary to consider the need for reform separately from prospects for reform (and we shall presently see that such an exercise may be useful), then it take a closer look at three criteria used in the ranking, namely:

  - Urban Concentration
  - Quality of Bank Management

380

- Quality of Central Bank Controls

If these three happen to point to serious problems, then this certainly suggests an acute need for reform. If they do not, while this may lower the ranking of the country in terms of its need for reform, they do suggest that the country may be better able to handle financial sector reform projects; good rural outreach and bank management quality increase the prospect for handling credit facilities and projects stressing innovations, while good Central Bank supervision and monitoring of financial institutions reduces the chance of disaster in the aftermath of financial sector liberalization. In essence, what this suggests is that financial sector reforms must be planned in stages as suggested in the section above on the nature of financial sector reforms. It also points to another use of the ranking criteria; individual criteria can be looked at in isolation to establish a comparative evaluation of one or more prerequisites for the success of specific reform projects.

- Finally, it must be pointed out here that there is no lack of criteria other than those in our list that could have been profitably included in the ranking scheme. One obvious one is the commercial banks' loan/deposit ratio, a high ratio being presumably indicative of "aggressiveness" on the part of the banks, suggesting that they would be good candidates for expansion into new areas if controls were lifted. That ratio is, however, difficult to use comparatively; it is not available for some countries, and means different things in different countries. It also by no means unambiguous; a high ratio may be a sign of foolhardiness and lax control rather than of aggressiveness.

Other variables that we considered included required reserve ratios (which were not binding and hence meaningless in some countries), noninterest and transaction costs, on which information was sparse, and the degree of monetization (M2/GDP), which, despite inaccuracies related to the measurement of GDP, seemed to be universally low and hence of limited use in ranking.

184

3. Discussion of Results

a. Macroeconomic Ranking:

(i) Overall Results:

One of the most important revelations of the ratings assigned to the different countries according to the stability of their macroeconomic environment is the confirmation that the macroeconomic environment in most of our sample countries is far from stable. The average rating for each of the criteria in the table was higher than 2, implying relative instability or worse. In four areas it appeared that our sample countries were in rather critical shape: government deficit as a percentage of GDP, current account deficit as a percentage of GDP, debt-service ratio and real per capita growth. The situation with inflation was somewhat better, though pointing to continued instability on average. Progress on current account and capital account liberalization pointed to the least disastrous macroeconomic situation on average; still, progress in that area appears to have been for the most part limited.

(ii) Explanation of Results for Each Country:

Guinea (Average Rating: 1.7):

Guinea was tied as highest-rated for macroeconomic stability. Considering that inflation is high and is reported to have jumped dramatically recently, this may seem counterintuitive. However, since the increase in inflation occurred in the wake of a massive devaluation carried out in the context of a far-reaching structural adjustment program, it must be seen as a side-effect of a desirable development. On the whole, Guinea has made considerable progress in implementing macroeconomic reforms, as evidenced by its progress and current and capital account liberalization.

Rwanda (Average Rating: 1.7):

Rwanda's high rating for macroeconomic stability came as no surprise. The management of Rwanda's economy has been extremely conservative, indeed sometimes sinning on the side of caution. The government sector has been small, however, which has prevented government retrenchment from hurting the economy. Rwanda has also had the good luck to be an exporter of coffee, whose price has been high lately. However, heavy dependence on one exports suggests this good performance is very precarious, especially as the current

390

and capital accounts are still subject to constraints.

Kenya (Average Rating: 2):

Good prices for Kenya's main agricultural exports, coffee and tea, have contributed to the health of the economy. There has also been a period of strict demand management in 1982/83, but no real structural adjustment. The precariousness of dependence on coffee and tea exports points to potential current account troubles ahead.

Malawi (Average Rating: 2.1):

Malawi's good economic performance continues to surprise most observers. Fiscal policy has been responsible, and the country has had the good fortune of having very good weather in recent years. An important factor in Malawi's good economic record is the fact that it has been willing to maintain close ties with South Africa, which have proven highly lucrative.

Niger (Average Rating: 2.3):

Niger's average performance reflects the implementation of some desirable reforms coupled with a serious drought that temporarily crippled the economy. Debt relief has been a factor in minimizing the economic disruption. The policy environment is not altogether hopeless; membership in UMOA provides for some monetary control and bank supervision.

Mali (Average Rating: 2.6):

Mali's weak performance reflects the relative lack of fiscal responsibility which continues to be a serious problem. High debt-service commitments are also problematic despite debt relief. Membership in UMOA has averted high inflation and maintained a modicum of monetary control.

Senegal (Average Rating: 2.6):

Senegal has come very late to structural adjustment and made little progress thus far. Debt is a serious problem and exports have very limited growth potential, suggesting the need for far-reaching restructuring which the government is resisting. Membership in UMOA has prevented inflation from mushrooming and insured a measure of monetary control.

391

Somalia (Average Rating: 2.6):

Somalia's resources are very limited and government policy has been highly irresponsible, resulting in massive fiscal and external imbalance. Saudi Arabia's decision to halt exports of most Somali livestock almost destroyed the economy, but some success has been recorded in finding alternative markets. The government has not been mildly receptive to reform, but slow to act because of ideological and sociopolitical constraints.

Sudan (Average Rating: 2.7):

The weakness of cotton prices is but one factor underlying Sudan's dismal economic performance. The government has been highly resistant to meaningful reform, and fiscal imbalance has been intensified by continued fiscal irresponsibility and misallocation of resources by parastatals.

Zaire (Average Rating: 2.7):

Zaire's dependence on copper and cobalt exports has had a highly adverse impact on the economy, as the price of both commodities has been and is likely to remain depressed. In addition, the government has borrowed heavily from banks and overseas, and the debt burden is extremely heavy.

Zambia (Average Rating: 3):

Zambia's disastrous economic situation stems from the collapse of structural adjustment efforts and the restoration of unsustainable controls on prices and currency evaluation. The debt problem continues to be severe with no relief in sight, and the failure to diversify away from dependence on copper points to a bleak future.

(b) Financial Sector Ranking:

(i) Overall Results:

The results of the ratings given to different countries according to the strength of their financial sector (and hence its need for reform) confirm our view that the financial sectors of nearly all the countries in our sample have serious problems. The ratings average less than 2 (the lower the rating the better the state of the financial sector) out of a possible 3 in only two areas: real loan rates being sufficiently high and the quality of bank management. The most serious problems appeared to be poor Central Bank controls and individual bank credit ceilings, which proved to be quite common. A high public

392

sector share of domestic credit, a high incidence of nonperforming loans, and insufficient progress on financial sector reforms were only moderately less acute, as was the high government share of ownership of financial institutions. Repressed deposit rates and high urban concentration were also fairly serious almost throughout our sample.

(ii) Explanation of Results for Each Country:

Guinea (Average Rating: 1.7):

Guinea's financial sector has experienced substantial improvement because of recently adopted deregulation. The adjustment phase the country is now undergoing is likely to prove difficult for the financial sector, however, especially as inflation is quite high. Also, as information of Guinea is very difficult to obtain and what information we have is not wholly reliable, there is reason to believe that there may be hidden weaknesses in the sector.

Rwanda (Average Rating: 1.7):

The financial sector has been conservatively managed, but some individual institutions have achieved rapid growth. There is relatively little repressive regulation and only moderate domination of the financial sector by the public sector.

Zaire (Average Rating: 2.2):

The financial sector shows some promise because of recent deregulation. The little strength that the sector enjoys, however, appears to stem largely from the small size of the banks and the conservative nature of their loans, which are hardly positive signs in themselves.

Kenya (Average Rating: 2.4):

The weakness of Kenya's financial sector stems largely from the gross unsoundness of parastatal financing institutions, and, to a lesser extent, from the unrestrained growth of nonbank financial intermediaries. An equity market exists but is underdeveloped, and the success of commercial banks to date appears to be a result of their ability to bypass restrictive regulation.

Malawi (Average Rating: 2.4):

Malawi's financial sector is characterized by heavy

393

domination by the public sector, very low interest rates, and a fair amount of repressive regulation. About the only redeeming feature is good managerial skills in the financial sector. Some progress has been made on financial sector reform, however.

Mali (Average Rating: 2.4):

Mali's financial sector has serious problems stemming largely from the gross inefficiency of the state owned development bank, which has absorbed most of the debt of the parastatal sector. There is also some repressive regulation, although real loan rates are positive. Some progress has been made on financial sector reform.

Niger (Average Rating: 2.4):

The financially sector is tightly constrained by regulation, and heavily controlled by the public sector, whose debt it has absorbed through the state owned development bank. The government is barely beginning to address financial sector reform.

Senegal (Average Rating: 2.5):

The financial sector is heavily dominated by the government, and an enormous share of credit is to parastatals. The financial sector has been shaken by severe shocks, among them the collapse of ONCAD, which accounted for more than a third of bank loans.

Sudan (Average Rating: 2.7):

Sudan is a seriously overbanked country with a large number of poorly run, inefficient banks, many of which are technically bankrupt. Islamic banking has not brought about the expected good results, and has introduced confusion into the system. The application of credit controls has discouraged banks from taking deposits.

Somalia (Average Rating: 2.8):

Somalia's financial sector is one of the most primitive. It is a total government monopoly, and is known to be managed very inefficient. There is only one commercial bank and one development bank, and thus no competition whatever. Operational efficiency is also judged to be low.

Zambia (No Rating Due to Lack of Information):

Little information is available about Zambian financial institutions, but it is known that Central Bank controls are weak, that problems exist in the sector (especially in parastatal financing institutions), and that little progress has been made on financial sector reform. It

394

seems safe to assume that the financial sector is in as bad a shape as the rest of the economy.

(iii) Comments on Results:

- There appears to be a fairly strong correlation between the instability of a country's macroeconomic environment and the weakness of its financial sector. Thus the countries most in need for financial sector reform are typically not ready for too much of it because they must first restore stability to their macroeconomic environment.
- Countries with highly restrictive regulation tend to have problems in many areas relating to their financial sectors, especially in the degree of nonperforming loans.
- UMOA countries appear to have the advantage of relatively better Central Bank controls (and also of somewhat more stability in their macroeconomic environment, though that is not universal) than the other countries.

E. GUIDELINES FOR ALLOCATING USAID FUNDS TO FINANCIAL SECTOR REFORM PROJECTS

We feel that the optimal approach to allocating USAID funds to financial sector reform projects is to use the ranking schemes outlined above to determine the following:

- How stable the macroeonomic environment is. A highly unstable environment suggests that the time is not right for far-reaching reforms. Thus, countries which rank low as far as macroeconomic stability are concerned should not be considered for massive financial sector restructuring projects for the time being.
- How pressing the need is for financial sector reform. In all the countries we considered, some financial sector reform is needed, a good deal of it more or less urgently. The countries with the gravest weaknesses in their financial sectors need to be given priority for funding of the kind of reform they are able to handle, namely reforms aimed at strengthening existing financial institutions.
- What kind of reform the country is ready for. In nearly all cases, reforms involving the strengthening of existing financial institutions can be contemplated, even if the macroeconomic environment is unstable. Financial sector liberalization on a large scale should be attempted only when a measure of stability has been achieved in the macroeconomic environment. On the whole, however, liberalizing reforms and more ambitious reforms aimed at increasing competition in the financial sector may be contemplated early in the case of some countries, the appropriateness of specific reform being a function of particular conditions prevailing in each country.

We suggest a three-pronged approach to financial sector reform. sector reform. The primary reform process, which is needed in all countries but most imperatively in the countries

395

with the weakest financial sectors, should focus on basic reforms aimed at strengthening existing and reforming existing financial institutions. The fact that many of the countries most in need of these reforms are often in highly unstable state as far as their macroeconomic environment is concerned does not preclude the possibility of basic reforms, which need not be blocked by instability of the macroeconomic environment. Indeed, these reforms are often conducive to an improvement in the macroeconomic environment, and go hand in hand with structural adjustment efforts.

Liberalizing reforms should ideally be reserved for countries with both a relatively stable macroeconomic environment and, in some but not all cases, a strengthened financial sector. Prior liberalization of the current account is of the essence, to avoid having the financial sector adjust to price signals which are out of tune with international prices.

Reforms aimed at revitalizing the financial sector by increasing competition are also imperative in many countries, and can be contemplated fairly early for countries whose particular conditions make them candidates for this type of reform. Although they often are ambitious, such reforms can be contemplated at various stages of financial development.

Thus it would be desirable to allocate funds for basic reforms in all the countries in our sample in the near future, but most imperatively for Sudan, Somalia, Senegal, Mali and Niger, which have the most acute need for basic financial sector reform.

Liberalizing reforms require proceeding with more caution. As they have already been largely introduced in Guinea, it will be interesting to see how reform fares there, and whether financial sector liberalization did not prove premature in Guinea's case. Financial sector liberalization can eventually be contemplated in Kenya and Malawi, assuming more progress on macroeconomic reforms and on restructuring parastatal financial institutions in both countries has been made.

The three-pronged approach to financial development is not meant to be an inflexible categorization of USAID projects. Reform by formula, always problematic, is singularly inappropriate in the case of financial sector reform. Extreme caution should be exercised in pushing for financial sector liberalization before the macroeconomic environment is ready for it, however; the potential for counterproductive results is too great.

3410