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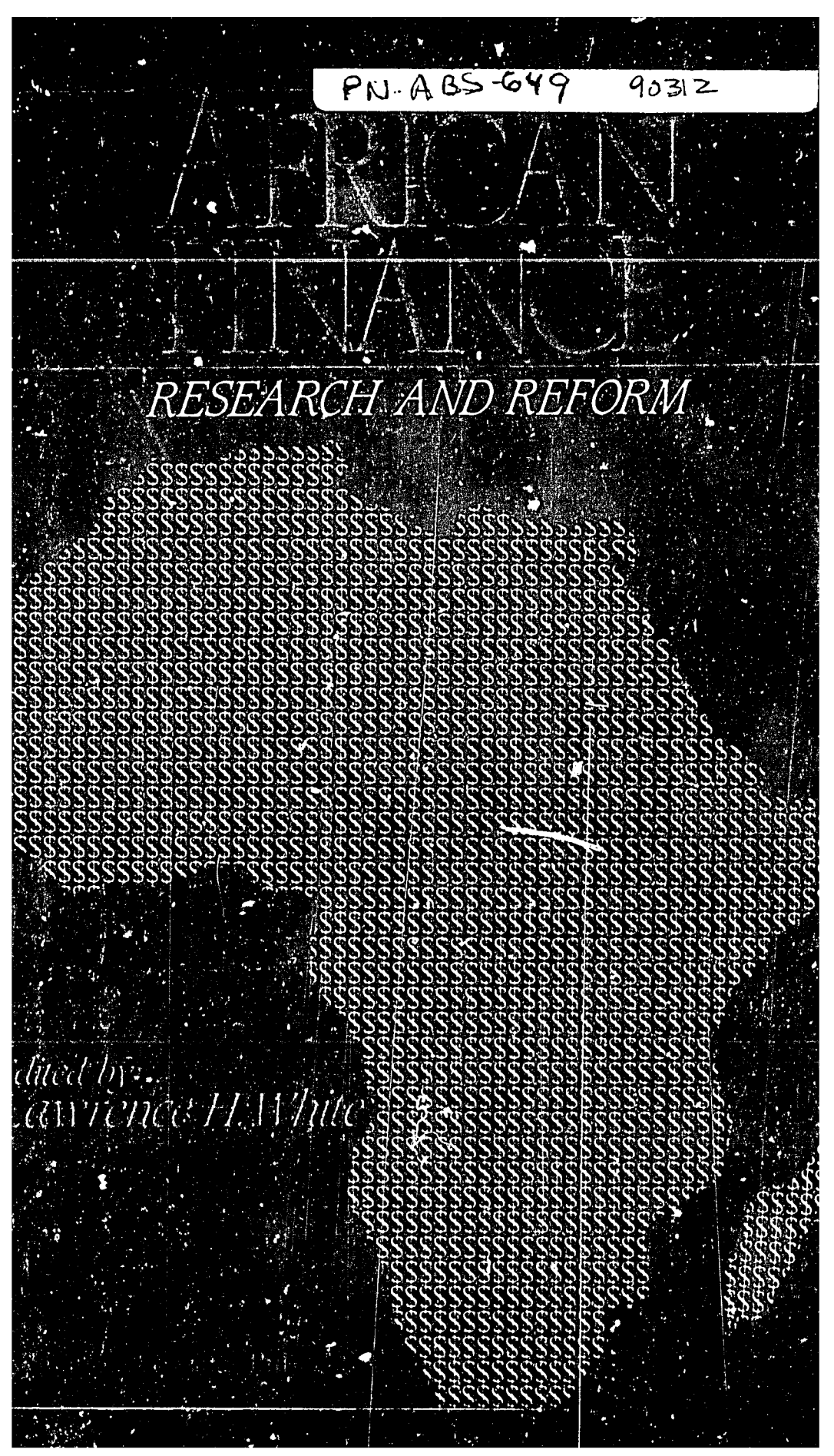
AFRICAN FINANCE

RESEARCH AND REFORM



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African Finance
Research and Reform

A Sequoia Seminar

Edited by
Lawrence H. White

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African Finance: Research and Reform

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Contents

Preface ix
Robert B. Hawkins, Jr.

Foreword xi
Jerry Jenkins

Acknowledgments xv

1 **African Finance: Toward Understanding and Liberalization** 1
Lawrence H. White

2 **African Finance in Global Context** 11
Millard Long

3 **Some Unresolved Issues in African Financial Reforms** 17
Jo Ann Paulson

Comment 25
Stephen O'Connell

Discussion 31

4 **Restructuring of the Banking System in Guinea** 39
Roland Tenconi

Appendix 62

Comment 67
Nancy Benjamin

Discussion 71

5 **Financial Restructuring in Ghana** 85
Barber B. Conable

Addendum I 107
Jacques Toureille

Addendum II 111
M. G. Sri-ram Aiyer

Appendix 114

Comment 121
Sergio Bortolani

Discussion 123

6 **Borrowing and Lending in The Gambia: Local Perspectives on Formal and Informal Finance in Agrarian West Africa** 133
Parker Shipton

Comment 163
Carlos Cuevas

Discussion 167

7 **The Impact of Adjustment Policies on African Informal Financial Systems** 177
Philippe Hugon

Comment 193
Anand Chandavarkar

Discussion 197

8 **Inflation in African Countries: General Issues and Effect on the Financial Sector** 205
Joshua E. Greene

9 **The Impact of Monetary and Fiscal Policies on the Financial System in Tanzania** 229
C. S. Kimei

Discussion (chapters 8 and 9) 263

Responses 269
Joshua E. Greene
C. S. Kimei

10 **Financial Crises and the Process of Adjustment in the Franc Zone: The Experience of the West African Monetary Union** 273
Patrick Plane

Appendix 297

Comment 299
Louis M. Goreux

Discussion 307

11 **Nonbank Financial Innovations in East Africa** 319
Anthony Saunders

Appendix 331

Comment 337
David Glasner

Discussion 343

12 **Innovations and Markets in African Finance** 353
Mohamadou Diop, Kenneth R. Locklin, Promodh Malhotra, A. B. Ndofor, and Lawrence H. White

Discussion 371

13 **African Financial Sector Research: A Conclusion for Today** 381
J. Clark Leith

Discussion 389

14 Separating Bank and State in Africa **411**
Lawrence H. White

Notes and References **427**

Contributors **445**

Seminar Participants **447**

Academic Advisers **449**

Index **451**

Preface

African Finance joins another Sequoia Seminar book, *If Texas Were Chile: A Primer on Banking Reform*, as a geographically centered application of the universal, abiding principles that were introduced in *Capital Markets and Development*, an earlier volume in the Sequoia Series. Each of these books affirms that the elementary developmental objective, financing enterprise, requires institutions that enable money to be matched with merit—thereby minimizing rewards to wasteful activities, indigence, and corruption.

It is helpful to think of financial and capital markets as institutions that fundamentally serve—as do well-functioning economies in general—to allow people to do more with their resources than they otherwise could. The daily activities of stockbrokers, bank loan officers, and other debt and equity intermediaries allow people's wealth to be matched with, to support, and to benefit from the best ideas and talents in society. Unfortunately for Africans, this match is nowhere realized less well than in the countries of their continent.

As this book reveals, capital markets in Africa, when they are not inadequate and underdeveloped, are simply absent (or, at best, informal). Because of this, much talent goes unrewarded throughout Africa. The earnings thereby lost also imply lost savings, and mean that what savings remain cannot be maximally employed.

Seen in these basic terms, the development of African finance is no more or less than a corollary of the expansion of African freedom. Thus it is

that this book may well exceed its stated objective of launching a research and reform program in African finance. Consistent with the theme of the Sequoia series, development in Africa, as elsewhere, is shown to necessitate efforts to "include the excluded" people of the world.

Robert B. Hawkins, Jr.
October 1993

Foreword

As Paul A. Volcker has observed, "central banks in the Western world . . . were not at the cutting edge of a market economy; they were Johnny-come-latelies. . . ."[1] In all of the world's most industrialized countries, market economies have developed *before* the establishment of central banks by those countries' governments. While the evolution of market economies is clearly integral to the development of countries, central banks are derivatives—at best—of development. Reading this volume, however, one is struck to note the establishment in every African country of a central bank before the emergence of a market economy, exactly reversing the earlier sequence experienced by each of today's most industrialized countries.

Africa has followed an untimely schedule for the establishment of central banks. Ruling politicians, unrestrained by the demand of market participants for the liquid, stable currencies that are most propitious for the functioning of market economies, have frequently been disposed to use their countries' central banks to supply their immediate revenue needs. In such circumstances, the value of currencies rapidly depreciates, and citizens rationally prefer cattle, jewelry, and other tangible, moveable, assets that are less subject to taxation or depreciation by governments. Hence do "funny money" and an intelligent preference for cows over cash come to be associated with countries where central banks have been established in the absence of market economies.

These considerations reinforce the urgency of a question asked during the conference from which this volume is distilled: Why are grants and loans to African governments made conditional upon so many other items of policy reform, but never upon the dissolution of their central banks and state-monopoly currencies? This omission from the conditionality roster seems to defer more to extant government authorities than to the logic and evidence of development history. It is to be hoped that such deference is not tantamount to a denial or forestalling of development. Otherwise, the misdirection of concern, attention, and resources may perpetuate the exclusion from the development process of millions of Africans who have never yet been included.

Because Africa's colonizers neither found nor left impersonal market economies on the continent, there may be no instances in history in which the formal independence of new countries has secured less freedom than it has in Africa since World War II. It is possible that most of Africa would be economically and socially more highly developed today if colonialism either had never occurred on the continent—or, given that it did, had not ended.

Colonialism brought diverse peoples, possessing disparate traditions and institutions, into sustained contact with one another within boundaries that scarcely recognized their respective histories and levels of development. The new countries that emerged were left with governments whose officials rarely shared the ethnic heritage of most of their citizens.

The arbitrariness of "national" boundaries determined by colonialists with no regard for preexisting ethnic antipathies impelled these new governments toward centralization. The exercise of some degree of centralization in circumstances of ethnic antipathy is not devoid of reason; it may be as appropriate to what was once Yugoslavia, for example, as to most African countries. But in Africa, such centralization has tended to be extremely narrowly based, a problem described by President Teodoro Obiang Nguema Mbasogo of Equatorial Guinea. President Obiang writes of the need to

> overcome first the savage aspects of our aboriginal ethic, ill suited for breaking the isolation of the tribes and organizing them in large states or broader societies ruled by common laws. Because of these tribal customs, political organization, instead of developing toward a more open and universalist human integration, has tended to consolidate personal power, identifying it with the leader's own horde, ethnic group, clan or tribe.[2]

The new governments of countries with more homogeneous populations are normally the beneficiaries of traditional institutions. In contrast, the new governments of Africa have been burdened by too many different traditional institutions, with the multiplicity of those institutions simply mirroring the heterogeneity of their populations. It is sad, but not surpris-

ing, then, that coercion and command, rather than contract and consent, have been integral to the practices of the new governments no less, and often more, than of their colonial predecessors. But nowhere have coercion and command fostered development, financial or otherwise. It is also not surprising, then, that most Africans employ the instruments and services of formal (that is, government-authorized) financial entities less than they do informal alternatives (whether traditional or newly created).

Had individual property ownership been broadly based before either colonization or independence, then the incentives that would have allowed a market economy to emerge might have withstood the impulse to centralization in the colonial aftermath. Instead, the general absence of a property-holding indigenous population possessing corresponding rights has meant that the powers of sub-Saharan African governments to exploit their citizens are unusually broad. The resulting centralization of government in Africa has had predictable and unfortunate results.[3]

Wherever freedom is the rule, individuals are able—unlike most Africans—to withhold resources from one another and from the state. The legal title of owners to their property gives them a capacity that the propertyless simply do not have for resisting arbitrary, capricious, or otherwise undesirable authority. And the more expansive and secure are an individual's property rights, the greater the likelihood and intensity of his resistance. The odds of resistance being *successful* are exponentially increased, of course, in a population within which the ownership and exercise of the rights of property is a general condition. Unfortunately, these modal elements of resistance are nowhere in the world more narrowly circumscribed and insecure than they are in Africa. Their tenuousness has little to do with the preferences or disposition of individual Africans, but much to do with the distribution of their numbers throughout a vast continent.

Greater population density than has been common in Africa may be a necessary, though not sufficient, condition for the emergence of economic markets and their integral elements. Specialized production—a corollary of the division of labor in society—requires the exchange (or trade) that only occurs in markets. Because of this, the very survival of specialized production and producers generally requires a large population of potential customers. If a given area's population is too small to permit specialized production, then infrastructure and technology for transportation and communication must be sufficient for overcoming the costs associated with geographical distance. None of these prerequisites for the emergence of markets have been realized generally in Africa, and potential suppliers remain out of touch with most of the continent's consumers. Thus has the contact among people that elsewhere has engendered individual property rights and contractual relationships been thwarted by the growth and distribution of African populations. And, once again, it is where most of the

population is lacking the experience of rights and responsibilities attending to property ownership and contractual relationships that central banks and other instruments of official governments are most subject to abuse and misuse by ruling politicians.

What might the governments and citizens of African countries do to ameliorate these egregious circumstances? What institutional changes might they accomplish to reduce the antidevelopment consequences of the steep transaction costs of fragmented economies? What changes in financial institutions and policies could either complement or be essential to other, more pervasive changes? The need for answers to these and many other fundamental questions was the catalyst for the international conference from which this book comes. No one should be satisfied with the answers found in this volume alone; after all, this book was conceived as a launching platform for further research. However, readers are unlikely to find another book on the financing of African enterprise that contains more of the right questions and considerations. Thus should future research in African finance be a beneficiary of this volume.

Jerry Jenkins
Series Director/Editor

June 1993

XV

Acknowledgments

A program of research into the organization of finance and financial practices of Africans and their governments was formally launched by the three-day (June 20–22, 1989) conference that is represented in this volume. Unlike other volumes in the Sequoia Seminar Series, this book reflects the proceedings of a conference jointly sponsored by the Agency for International Development (AID), World Bank, and International Monetary Fund (IMF). This expansive format allowed for dialogue greatly enriched by the diverse perspectives of outstanding African participants and an international cast of contributors appropriate to the aim of the conference: to develop an expanded and improved research agenda addressing African finance; and also to identify consensus on research priorities, thereby contributing to collaborative research.

Leonard G. Rosenberg, and the Bureau for Africa of AID which he represents, are the parties most responsible for bringing into existence the African Finance conference, and also for engaging almost all of the contributors to this book. In addition to Dr. Rosenberg, particular appreciation is extended to John R. Westley, who was then acting assistant administrator of the AID Bureau for Africa and who chaired the conference, to Jerry Wolgin, chief economist of the AID Bureau for Africa, who chaired the opening session of the conference, and to Edwin L. Hullander, Warren Weinstein, Neal S. Zank, Fred Kirschstein, Catherine R. Gordon, and Robert Young, who contributed greatly as AID project officers for the Sequoia seminar series. For their participation in both planning the conference and

chairing one of its sessions, special thanks are extended to: Michael N. Sarris of the World Bank; Alan Gelb of the World Bank; and Donald J. Mathieson of the IMF. On behalf of ICS Press, Janet Mowery, Peter Hayes, and Trudy Kaplan also warrant particular mention for bringing this manuscript into its present form.

Finally, I want to thank Lawrence H. White for editing this volume and, in its concluding chapter, for comparing the unique circumstances of present-day African finance with the eighteenth- and nineteenth-century experiences of what became the industrialized West.

Of course, none of the opinions expressed in this volume are necessarily shared by either Sequoia Institute or AID. Nevertheless, the volumes in this series are expected to provide substantial assistance to the activities of their readers who support the theme of the series: extending the benefits of development by including the excluded.

Jerry Jenkins
Series Director/Editor

June 1993

1

Lawrence H. White

African Finance: Toward Understanding and Liberalization

This volume is the product of a conference organized by the Bureau for Africa of the U.S. Agency for International Development (AID) with the cosponsorship of the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank). It includes the papers presented and the transcribed remarks of assigned commenters. More interestingly, it includes edited transcripts of the ensuing discussions among very knowledgeable participants. I was asked to edit the conference volume by the Sequoia Institute, working under contract for AID, well after the authors and other commenters had been chosen. I mention this because many readers may approach this volume with the same misapprehension I had in attending the conference. I expected to hear bureaucratic rationalizations for the failures of interventionist policies in the past, earnest calls for avoiding similar mistakes in the future, and presentations of central planning templates only marginally different from those responsible for past failures.[1] In fact, there is almost none of that here.

Virtually all the contributors, representing the international agencies as well as African governments and the African banking community, recognize that the financial development policies of the international agencies and

African governments in the 1960s, 1970s, and 1980s were far too interventionist. They agree that the way forward is through liberalization. The remaining questions are how far, how fast, and in what order to dismantle barriers to free financial markets. This is a remarkable and heartening transformation of the agenda for economic development. The old approach to development viewed the domestic financial system simply as an instrument for state planning. As Millard Long indicates in remarks that opened the conference, newly independent African nations in the 1960s found their inherited banking systems geared toward financing the export trade. To redirect the banks in line with then fashionable development ideas, governments nationalized existing banks, founded their own development finance companies, or imposed credit priorities.

Postcolonial arrangements have awarded credit to state-owned enterprises and "priority sectors" while crowding out the unfavored private sector. Domestic output has not risen, and the distribution of wealth has been skewed toward those favored by the state. Financial institution portfolios have been stocked with nonperforming loans to state-owned enterprises and to political friends of the government. With such distorted portfolios, combined with the normal dose of mismanagement endemic to enterprises undisciplined by the bottom line, the institutions have naturally proved vulnerable to external shocks adverse to the terms of trade. Insolvency has been the singular achievement of African state-owned and -regulated financial institutions.

Long notes that these insolvencies present opportunities for reform. African governments might close loss-making state-owned development finance companies. They might reconsider restrictions on private banks. They must do something with the insolvent state- owned enterprises whose bank loans are in arrears. The new policy thrust in many African countries recognizes the importance of the private sector for growth and acknowledges the vital role of a liberalized financial system in mobilizing resources through the private sector. Long correctly emphasizes that the necessary groundwork must be laid for a private, market-oriented financial system to flourish. At a minimum the legal system must secure private property ownership and ensure contract enforcement.

Reform and restructuring, driven by insolvencies, have already begun in a number of sub-Saharan nations, as Jo Ann Paulson reports in her informative survey. The fundamental issue is whether these reforms will establish a proper long-run framework for financial development or get the "rules of the game" right. The issue is *not* whether they will put in place any preconceived set of institutions. No one knows what the optimal set of financial institutions looks like. With this in mind, Paulson's question of whether it is safe to lower entry barriers can be reversed. If competition is not only a source of discipline on firms but also an indispensable means for

discovering what kinds of financial firms are really viable, is it safe ***not*** to lower entry barriers? As Donald Mathieson points out in the discussion of a later paper, it is not even clear whether African financial markets should follow national boundaries or which services should be domestically produced and which imported.

Consistently with this view, Stephen O'Connell argues in his lead commentary on Paulson that the right way to go is to facilitate the formation of new private financial institutions through reform of the legal and regulatory framework, rather than to design and impose new state-run institutions. O'Connell points to the critical problem of "regulatory failure" due to the perverse incentives faced by government regulators. The financial sector is a major source of revenue to African governments through seigniorage and bank taxes. Credit facilities are harnessed for political favoritism. These points reinforce one's skepticism about the chances for successful redirection, as opposed to shrinkage, of the regulatory apparatus.

In the subsequent discussion O'Connell notes the problem of *exit* barriers. For competition to operate properly, banks must be free to fail. Recapitalization of insolvent banks, as another participant remarks, short-circuits the learning process. Mohamadou Diop notes that whereas market forces (profit and loss) compel banks to be disciplined and responsive, supervision sometimes gets in the way. Millard Long summarizes the sense of the discussion: the needed institutions will come forward on their own once the correct legal structure is in place.

Roland Tenconi's consulting report on Guinea provides a case study of one government's recipe for bankrupting state-owned financial institutions and a subsequent government's program for dealing with their insolvency. Guinea's six state-owned banks went broke because they did not extend loans based on the credit-worthiness of their borrowers. Instead they were directed by the government to provide credits to state-owned enterprises, in amounts determined by the official development (central) plan, or to make loans to privileged private enterprises. A new government closed and liquidated the banks. It has established three new commercial banks with mixed government-foreign ownership, foreign management, and initially little apparent government interference in their operations. Regulations have subsequently increased. Entry barriers have yet to be dismantled, and the government has yet to disengage by selling its shares.

Nancy Benjamin's comment on the report raises a number of questions, particularly regarding the parallels between Guinea and other former socialist countries that have recently liberalized. The comments of Alain Soulard, who initiated discussion in the absence of Tenconi, and of Kerfalla Yansane, speaking from the floor as governor of the Central Bank of Guinea, throw additional and sometimes contrasting light on the Guinean

restructuring. All three, and several remarks in the subsequent discussion, touch on the question of corruption within the state-owned banks. Yansane also mentions that under the old regime currency was actually issued under the personal authority of the president, who would send the central bank orders to pay.

The conference's third paper was International Development Association (and World Bank)[2] President Barber Conable's report on Ghana's financial sector restructuring program. The abridged version included in this volume provides a second case study of restructuring. The remarks on the report by Jaques Toureille of the World Bank clarify the program's contents: a mixture of liberalization (of interest rates and sectoral credit allocation), new regulations (capital adequacy requirements, lending limits, reporting requirements central bank supervision and examination), steps toward resolution of bank insolvencies, and training assistance. The remarks by M. G. Sri-ram Aiyer, also of the World Bank, generalize about financial reform programs and the obstacles they face.

Sergio Bortolani's comment, based on his experience providing technical assistance in Somalia, forcefully makes a single point: the intricate steps and technical measures of a restructuring program are useless when the local government responsible for its implementation is fundamentally corrupt. "Government" here includes the officials of the state-owned banks. Bortolani finds it scandalous that donor funds go to corrupted ruling elites who are impoverishing their countrymen. Surprisingly, given the willingness to talk about corruption in earlier sessions, the subsequent discussion never addresses Bortolani's point. The Somalian bank officials in attendance do not comment.

Mohamadou Diop makes the interesting observation that even well-run private banks can suffer loan losses when a liberalization program eliminates the subsidies and monopolies that certain firms had counted on to generate the income to repay their bank loans. This unfortunately makes trade liberalization a more complicated matter. Philippe Callier adds the optimistic corollary that financial distress can therefore be a positive sign that distortions are finally being eliminated. Allowing banks to diversify across national borders would minimize the financial distress caused by purely local shifts in profitability (such as are associated with liberalization but which can also arise because of terms-of-trade changes and other causes). National borders are therefore unlikely to coincide with optimal banking territories in Africa (Donald Mathieson's point). Aiyer seconds this point.

Unofficial or informal financial institutions, like rotating credit clubs (or tontines), are important in many sub-Saharan countries. Parker Shipton's paper broadens our understanding of African savings and credit by examining rural borrowing and lending practices in The Gambia. Lending

appears in a variety of (unwritten) contractual forms, reflecting inter alia the seasonality of agriculture, the influence of Islamic prohibitions of usury, gender distinctions in property rights, and the common reliance on kinship and social ties to ensure repayment. Carlos Cuevas's comment draws parallels to practices in Guinea and Cameroon. He notes that repayment rates on informal loans are quite high because of the effectiveness of family and social pressure.

In the discussion J. O. Sanusi draws similar parallels to Nigeria, where he heads the central bank. He emphasizes "the beauty of the informal sector" in a way reminiscent of Adam Smith's appreciation of the invisible hand: "The beauty of it is that everybody does it in a way that he considers beneficial to himself and gets a result, although over time there is a pattern." In this view "informal" financial markets are simply free markets. Anand Chandavarkar reinforces this point in his later comment on Phillipe Hugon's paper. Clark Leith implicitly disputes this view, arguing that informal lending is segmented and noncompetitive and questioning whether it can be extended as a model for financial development. Parker Shipton replies with examples of larger formal institutions that have evolved from, or are emulating the practices of, informal lending arrangements. More fundamentally, he challenges Leith's apparent assumption that development planners should be looking for ways to interfere with indigenous arrangements, to extend them, or to use them as instruments of growth. Why not leave them alone?

The paper by Philippe Hugon provides a taxonomy of informal financial institutions, their links to official economies, and their possible dynamic responses to adjustment policies. Hugon mentions in passing the influential "financial repression" analysis of Ronald McKinnon (1973) and Edward Shaw (1973).[3] Anand Chandavarkar's comment suggests further distinctions but cautions that the formal and informal financial sectors are strongly linked. Many economic agents operate in both simultaneously (for example, shopkeepers who borrow from banks and relend to their customers) or graduate from the informal to the formal sector (such as borrowers whose credit demands and credit-worthiness grow large enough).

The discussion raises the question of why familiar Western financial institutions or contracts, such as venture capital or medium-term loans, appear to be "missing" in certain African economies. Some participants seem to consider these to be cases of mysterious "market failure." As David Glasner later indicates, however, an explanation can be sought in transactions costs that exceed the potential benefits. Other participants give examples illustrating the point that legal or regulatory failure is typically to blame for high transactions costs. The absence of particular financial contracts is explained by their legal nonenforceability, owing to explicit or implicit legal prohibition of the contractual provisions. Other contracts fail

to appear because entry barriers (for example, restrictive bank licensing) block those who might offer the contracts.[4] Legal and regulatory obstacles block certain organizational forms in the same ways.

From these very microeconomic concerns we turn to African macroeconomic experiences. Joshua E. Greene usefully surveys African inflations since 1975. The evidence clearly supports the quantity-of-money theory: countries that have more rapidly expanded their nominal money stocks have experienced higher inflation rates. The evidence does not show a similar link between fiscal deficits and inflation. Higher inflation is associated with more rapid exchange rate depreciation, as the monetary approach to exchange rates would predict. Greene also considers the negative effects of inflation—particularly in combination with fixed nominal interest rates—on financial markets and the economy as a whole.

C. S. Kimei's paper examines in detail the case of socialist Tanzania, where, under a regime of monopolistic state-owned banking, monetary policy oriented toward accommodating government credit demands, and financial repression (nonmarket interest and exchange rates), financial and economic well-being regressed markedly in the 1980s. As Kimei indicates, the Tanzanian decline forcefully illustrates the value of competition in banking, depoliticization of monetary policy, and financial and economic liberalization.

In the discussion of Greene's and Kimei's papers, Alan Gelb notes that in repressed systems where credit is allocated by decree rather than by market price, banks lose their competence at screening borrowers. This makes transition to a liberalized system more difficult. I would add that it also makes liberalization all the more crucial. J. O. Sanusi argues that there is a causal connection between fiscal deficits and inflation in many African countries, despite the apparent lack of a statistical correlation, because central banks finance deficits by high-powered money creation. Patrick Honohan and C. S. Kimei reinforce this point with specific examples. Greene agrees that the method of financing deficits matters for inflation, even though the size of the deficit per se may not seem to matter.

Discussion of the different money-printing proclivities and corresponding inflation experiences of African countries naturally raises the question of how their monetary regimes differ. The franc zone countries of West and Central Africa, committed to maintaining a fixed exchange rate parity with the French franc, are constitutionally restrained from printing money *ad libitum*. The fixed exchange rate ties their price levels and inflation rates to those of France, and consequently their inflation rates have been lower on average than in the rest of Africa. The paper by Patrick Plane and comment by Louis M. Goreux explain the management of this regime by the West African Monetary Union and its central bank.

Plane notes that members of the union have suffered balance-of-payments crises. This is of course a common difficulty with a fixed

exchange rate regime managed by a central bank. A central bank is typically more eager to expand credit when gains in external reserves (for example, due to favorable movements in the terms of trade) make expansion possible than to contract credit when reserve losses make contraction necessary. As Goreux says, the adjustment up is easy, but the adjustment down is painful. There are political and budgetary pressures for expansion but none for contraction. A balance-of-payments crisis is the occasion, to put it optimistically, when the constitutional restraint on money creation finally (if belatedly) exerts its discipline.

The disciplinary effect of the franc zone regime, both directly on money creation and consequently on government budgets, is the main topic of the ensuing discussion. Sergio Bortolani, in common with Plane and Goreux, attributes the relative inflation-rate success of the franc zone to its monetary discipline (rather than to French intervention). Brian Ames makes the argument (often made regarding the classical gold standard) that the maintenance of the fixed parity reflects, rather than provides, the discipline of the monetary and fiscal authorities.

The last topics of the conference were nonbank markets and financial innovation, introduced by Anthony Saunders's analytical survey of East African nonbank financial innovations. Drawing on the work of other economists, Saunders distinguishes between "market completeness" and "constraint-induced" theories of innovation and outlines the principal proximate causes for the appearance of new financial products. He then applies the causal framework to three East African countries: Tanzania, Kenya, and Mauritius.

David Glasner's comment usefully shows how the second theory of innovation can be subsumed under the first, unifying and simplifying the analytical framework. Innovation occurs when the potential benefits from a new financial instrument are newly seen to exceed the costs of creating and marketing the instrument. Either its benefits have risen (for example, because regulatory or tax policies have eliminated alternative instruments or because macroeconomic policies have increased the level of uncertainty in the market against which traders need to hedge), or its unit transactions costs have fallen (for example, because technology has advanced, legal barriers have fallen, or the potential market has grown). In the discussion Michael Sarris succinctly summarizes an implication of the analysis: "when an economy is overregulated, overtaxed, and distorted, people will innovate to find ways around overregulation, distortion, and overtaxation."

To decide whether a particular financial innovation is a sign of improvement, one has to ask whether it was due to a policy change and, if so, whether that policy change was an improvement. Glasner argues that a very definite policy improvement would be to eliminate the uncertainty that stems from having a central bank. He advises that external aid be made contingent on a recipient country's undertaking the policy improvement of

abolishing its central bank in favor of a contractually constrained free banking system. This sort of conditionality is of course rather unlikely as long as donor nations retain their own central banks.

Surprisingly, no one challenges Glasner's advice in the ensuing discussion. Michael Sarris asks how policy advisers can tell when a country is ready for a particular new financial product. Jerry Wolgin asks again why we see "missing markets." The benefit/transaction-cost framework can help to organize an answer, because explaining a missing market (a *non*innovation) is simply the converse of explaining an innovation. To block a financial market, transaction costs must exceed the potential benefits net of other costs. The usual reason for high transaction costs is the presence of legal and regulatory barriers that people have not yet circumvented. Saunders gives the example of regulatory restriction on stock issues in Kenya. Donald Mathieson emphasizes the restrictive effects of tax laws and regulations, designed to raise revenue from the financial system, around which innovations are attempted. Both Mathieson and Saunders mention principal-agent monitoring problems as sources of transaction cost. But the need to monitor, based on lack of ex post contract enforcement, again depends greatly on legal and regulatory restrictions.

An especially interesting part of this book presents the perspectives of four individuals who have actually done business in sub-Saharan financial markets. Their remarks illustrate the various obstacles to African financial enterprise. Mohamadou Diop of Afribank, a private commercial bank with branches throughout the West African Monetary Union, discusses its efforts to identify niches for banking services in the market. One example: the prevalence of cash transactions led the bank to try to market a sort of traveler's check as a safer substitute. Regulatory restrictions have blocked the product in all but one country.

Kenneth Locklin of Equator Advisory Services reports on a joint private–U.S. government effort to develop a venture capital fund to raise private foreign equity for investment in private enterprises in sub-Saharan Africa. Lack of currency convertibility has restricted the range of the fund's potential investments.

Promodh Malhotra, manager of the syndications department of the World Bank's International Finance Corporation, relates the lessons gained from years of trying as an outside agency to create viable institutions to meet financial needs in African countries. The first lesson is that intimate knowledge of the local economy and social practices is needed. Malhotra gives the illuminating example of learning from experience how not to collateralize a loan in Kenya. The second lesson, reaffirming Diop's perspective, is that domestic savings exist in Africa but that tapping them can be quite difficult. Malhotra concludes that what African economies need for development is not innovative institutions as such but demand-oriented institutions that can pass the market survival test.

A. B. Ndofor, manager of the Cameroon Cooperative Credit Union League, explains that the informal-sector tontines (or *djanggis*) have certainly passed such a test and that they provide further evidence of the existence of savings. Ndofor underscores the important question of whether the legal framework allows financial systems to evolve on their own.

The ensuing discussion provides fascinating insight into the image formal financial institutions have among the ordinary citizens of Africa. Diop observes in the discussion that tontine contributors are usually women, who cannot trust banks to keep their savings secret from their husbands, or informal traders who view Western-style bankers as corrupt. Malhotra comments on the financial sophistication of these traders: "they know that when their savings go to a formal bank the government, in their words, steals 30–40 percent of it" through reserve requirements and squanders it.[5] Diop adds that migrant workers, approached by his bank as it researched demand for a money transfer service, have said that they would not trust a public sector bank with their money. J. O. Sanusi dissents somewhat from this discussion, citing evidence from Nigeria indicating that rural people are willing to use local branches of formal banks.

Clark Leith, in remarks presented at the conference, and I, in an essay written later, conclude the volume. Leith places a number of important questions on the research agenda. In particular he raises the question of the optimal evolution of financial systems. Should financial deepening and growing sophistication occur through building on local traditions or through the emulation of foreign practices? I am reminded here of Walter Bagehot's well-known aphorism: "Credit is a power which may grow, but cannot be constructed" (1873: 69).

The discussion following Leith's remarks lengthens the research agenda considerably. Alan Gelb pertinently suggests, among other topics, studying how African governments are using their financial systems for revenue extraction and cross-subsidization (through directed credit) of favored enterprises. Joseph Goodwin and Michael Sarris interject notes of political realism regarding the power of good ideas to overcome vested interests in the reform of African financial systems. Patrick Honohan adds that vested interests can block contract enforcement. Building up the infrastructure of contract law is probably the reform most necessary for fuller financial markets.

A number of participants propose collaboration on research projects among the IMF, the World Bank, AID, academics, and African central banks. These proposals perhaps call for a bit of critical consideration. If the international agencies and central banks engage academics to help evaluate their successes and failures candidly, the results could be useful. If they use them otherwise, as there are obvious incentives to do, there is danger of compromising the independent appraisal of the agencies' and central

banks' activities. A possible antidote would be independently funded appraisal by academics working with participants in the informal financial communities. This volume's quest for research and reform of financial development policies might be facilitated by—indeed might require—just such . reform of research itself.

That said, the reader will be aware of the need to judge the degree of candor in the following chapters. As I said at the outset, I was pleasantly surprised.

- 11 -

2

Millard Long

African Finance in Global Context

Except for specific examples drawn from the African context, the issuance in 1989 of the World Bank's annual *World Development Report* did not address African finance. We do believe, however, that the general lessons drawn in the report apply to Africa no less than to the rest of the developing world.

Let me just say one or two words on why I think finance was chosen as the topic of the twelfth *World Development Report*. Each year the bank selects a special topic to which it devotes its annual development report. The topic of domestic financial systems had never before been a topic of the development report. I think it was chosen this year (although I was not involved in making that choice) because we are beginning to see that financial systems are very important in developing countries in the whole process of mobilization and allocation of resources and in handling the problems that are associated with risk. And, as the development paradigm seems to be changing from a focus on government finance to one that draws more on the private sector, people are beginning to put more emphasis on the financial process.

There is a second aspect of the increased attention to domestic financial systems. The 1990s are probably going to be more like the 1980s than they will be like the 1970s. With the exception of some of the sub-Saharan

countries where official development assistance will be available, countries are not likely to experience a large flow of resources on commercial terms from abroad. Countries that want to finance a higher level of investment than in the 1980s, something more akin to the 1970s, are therefore going to be more dependent on domestic resources, both for the mobilization of resources and for developing their own sources of term finance.

I think that a third reason why finance was chosen as the topic of a development report is that we have come to realize in the past four or five years that the financial institutions in most of the developing countries are in serious straits. I think it is fair to say that most of the institutions in the sub-Saharan region would be in even greater difficulty if assets were marked to market. That is, taking due account of their bad loans, many of these financial institutions would be insolvent, having liabilities greater than the cash for which their assets could be sold in the market. This phenomenon is no less true in many countries throughout the world than it is in Africa.

At the time of independence of most African countries, their financial systems were inherited colonial financial systems. Thus in the 1960s most consisted of foreign-owned banks with branches in the port cities and perhaps the capital city focused on providing short-term financing for trade.

The inherited colonial financial systems were often considered unsuitable for financing the kind of development projects that would emphasize industrialization to a certain degree in conjunction with small-scale agriculture. Most of the banks of the inherited systems might have been lending some money to large-scale (plantation) agriculture but not much to small-scale agriculture.

To get the financial systems more in line with the development process that was being envisioned by newly independent Africans, most of these countries nationalized one or more of the banks and started government banks of their own, often called development finance companies (DFCs). The DFCs would have been no more or less than most other commercial banks except that the newly independent governments of the 1960s typically instituted a set of controls whereby they directed the financial institutions to make loans to the people that government officials considered to be in the priority sector.

The government itself and the public enterprises were usually the chief beneficiaries of this direct credit. Much of it went to the government. During the 1980s, particularly, less foreign funding was available, and the governments were still running quite substantial deficits. In that circumstance the amount of credit that the governments took out of the financial system for financing themselves or the public enterprises either crowded out the private sector or increased the rate of inflation. In many countries there was simply too much credit creation.

The impact of these programs and this approach to finance was a little difficult to judge, particularly on output. It is appropriate, then, to look at two other dimensions that are relevant to an evaluation of the financial programs of the newly independent governments. Were they successful in redistributing income? The evidence on this dimension is rather convincing: the programs were not very successful in redistributing income. Too often the credit went to those who were better off in the scale of things; the really small farmers and microenterprises did not have access either to credit from the financial system directly or to the directed credits of the DFCs. Though the evidence is not totally clear, it appears that in most cases the new systems were not very good at redistribution.

The evidence on the impact of the new financial programs on their financial systems to date is very clear. Many of the loans were not repaid because they were made to public enterprises that were not able to repay because they were prohibited from charging prices that would allow them to have sufficient profits to do so. Other loans to public enterprises were not repaid because the inefficiencies of the enterprises prevented profits sufficient for repayment even by firms that were allowed to charge prices that would otherwise have allowed repayment. In addition to nonrepayment of loans by public enterprises, many of the priority sectors in the private sector do not feel the need to pay. It has been very rare, for example, that governments have foreclosed on small farmers to force them to repay credits. As a result arrears have built up to the point where, as stated, most of these institutions are really in dire straits.

Though the recessions that have plagued many African countries are at least partially attributable to poor prices for the raw materials of primary commodity exports that many of these countries are dependent on, these very adverse shocks have exacerbated the problems created by the strategies that these countries followed. The shocks that these economies experienced starting in the 1980s when interest rates rose and the grim situation that exists today can be traced to the directed credit policies that were followed in the 1960s and 1970s. Anyone with foreign exchange risk saw a multiplication of the domestic value of their loans as many African (and other) countries adopted massive devaluations of their currencies.

In addition to their errors of financial policy, the substantial mismanagement of financial institutions in African countries is certainly no less than that of the United States and other countries throughout the world that has been so widely publicized in the 1980s.

If one really wants to understand these problems and to respond to them seriously, one has to look at the quality of the management systems. It would not be too hard to deal with these problems in the financial sector, except that it is always embarrassing, especially for a government in power. Many unjustifiable loans will be discovered to have gone to political friends of the government, and governments do not like to own up either to the

use of such money for political purposes or to the nonrepayment to the government of loans received by their friends. That is a very difficult and embarrassing problem.

The technical side of dealing with the financial institutions is not very difficult. It is going to be expensive, however, because governments have by and large decided that in straightening out the mess they will require taxpayers, rather than depositors, to bear the losses. Governments thus committed have to step in and pay a bill that is not inconsequential in terms of cash payments. Because these are in fact transfer payments from taxpayers to the liability holders of the financial institution, they do not constitute an outright economic loss. The economic loss lies in the firms—in the underlying borrowers who today are not able to service their debt. This economic loss is much more difficult to straighten out. In the African context, the biggest of these bad debts resides in the public enterprises.

Instead of restructuring financial institutions, therefore, the circumstances require the much more difficult task of restructuring firms. Among other things, that means laying off lots of people, trying to change prices so that they make sense in terms of the new relative prices resulting from currency devaluations and increased openings of economies to the international economy.

This is why I view the financial sector as being very important but a mirror image, nonetheless, of what is going on in the real economy. I perceive the problems that exist in the financial sector as being brought about either by mistaken macroeconomic policies or by bad relative prices or by the need to restructure the economy. I also view the fraud and mismanagement problems as reflections, in the financial sector, of the problems that lie in the real sector.

The portfolios of a country's banks are where substantially all an economy's mistakes are recorded because all the mistakes show themselves in the form of bad loans on the books of financial institutions. But it is the real economy, as I say, that poses the root difficulty.

What kind of changes in the system do we think need to be made? Whatever is one's view of the 1990s will, and should, strongly influence these anticipated changes. In many of the countries in Africa there seems to be recognition of the growing importance of the private sector. With that change in the paradigm, the financial system will need to become more responsive to the private sector, and that often means putting in place better infrastructure for finance by improving the legal structure, improving the accounting system, and improving prudential regulation of financial institutions. If the governments give up direct ownership of the financial institutions or even move back from direct intervention in those financial institutions, an alternative system has to be put in place.

Private financial institutions in Africa, whether run by British, French, or Africans, are subject to fraud and mismanagement. So the government

has to look at the way these institutions operate. That requires a capability of the central bank or of a deposit insurance agency to supervise and monitor what the financial institutions are doing. We have seen that there is not a very good prudential system in place in much of Africa.

So laws are needed for the enforcement of contracts. And accounting systems are needed so that people in the private sector can make sound judgments about the people to whom they are asked to make loans. After loans are made, such accounting systems of borrowers facilitate monitoring of their behavior and enforcement of their contracts. These assessments and requirements in the real sector thereby contribute very directly and essentially to the prudential system that is expected to ensure responsible behavior at the institutional level.

Fortunately, with regard to institutions, it is an ill wind that does not have some advantages; problems of insolvency afford an opportunity to restructure the system. Once DFCs, commercial banks, or nonbank financial intermediaries are bankrupt, a very real opportunity exists to decide what to do with them, whether to restructure them or to allow them to fade from business. Because banking behavior has changed in the 1980s from what it was in the 1960s when many of these institutions were founded—DFCs and commercial banks now make term loans, for example—it may not be necessary to have DFCs.

So the kind of system to be put in place warrants considerable thought. Questions that must be addressed include what kinds of financial services are needed in the economy and what kinds of instruments and institutions are needed for those services to be provided. The current need to restructure gives us an opportunity to address these fundamental questions.

Some of these transitional issues are covered very well by Jo Ann Paulson in the next chapter. We are now beginning to see some experience—not all of it happy—with financial restructuring in Africa. Some countries have started along this path, and some of them have found it a bit rocky. We need to think what kinds of things come first. It seems to me that macroeconomic stabilization and getting some kind of restructuring in the economy should probably precede much of financial liberalization. It does not make sense to free up the interest rates or eliminate capital controls if that is going to lead to capital flight or even capital inflows. A rather stable macroeconomy is required before beginning the process of financial liberalization. The things that can begin immediately are also very time consuming, like putting into place the necessary prudential regulations and revising the legal system. All this can be done and should be done even if the time is not ripe for completely liberalizing other aspects of a financial system.

17

3

Jo Ann Paulson

Some Unresolved Issues in African Financial Reforms

A quick survey shows that many African countries faced financial sector problems during the 1980s ranging from stagnation to instability of a few institutions to concern about stability of the whole system. This is not surprising since the banking systems had been integral parts of the economic systems now under stress and reform. The underlying causes of the problem vary across the continent, and generalization violates the diversity of Africa; however, several issues seem common. As the basis for discussion, it is possible to propose some features common to many of the distressed financial systems:

- The financial systems are thin and segmented, with very little competition or innovation.
- The financial institutions have been operating under perverse regulations and incentives within distorted poor economies.
- The financial sectors have been vulnerable to international shocks as well as the downturn in domestic economic performance in the 1980s.
- The governments have been heavily involved in ownership and management of financial institutions, particularly the development finance institutions (DFIs).

- Governments have regulated and operated the financial systems to allow political intervention to overrule commercial management decisions.

Early Reform Efforts

Because of deterioration of some weak financial institutions and the potential benefits of coordinating financial reforms with broader economic reform programs, many African countries have started financial reform programs since 1980. In many countries the early reforms have been driven by the need to deal with insolvent or illiquid institutions and financial distress. Unchecked financial distress can lead to erosion of confidence and discipline in the banking system, perverse credit allocation to loss-making clients, a shortage of credit for new clients, and a potential for bank runs.

The short-run stabilization programs for weak financial institutions must be coordinated with movement away from the repressed distorted systems of the past toward more flexible liberalized financial systems. Reform programs have included a mixture of macroeconomic policy reforms; rationalizing financial sector policies; and strengthening the operations, regulations, and supervision capacity of the central bank. Most African reform efforts are in the very early stages. Countries are still debating objectives and new policies. The process of implementing new macroeconomic and financial policies and strengthening the operations of the central bank will take years. The problems and approaches to reforms will be different in the nationalized and the mixed banking systems.

Nationalized banking systems. The countries with nationalized banks have had problems ranging from stagnation to systemwide instability. Several of these countries are starting to dismantle the systems that used banks as extensions of state budgets to allocate resources. Mozambique, Tanzania, and Angola are restructuring and breaking up, but not privatizing, the large government banks. The reforms in Guinea involved restructuring and partial privatization of the state banks with foreign partners. Madagascar is restructuring the state banks and considering the possibility of foreign partners. There have not been significant financial reforms in Somalia and Ethiopia.

Mixed banking systems. Most countries on the continent have mixed banking systems with foreign, private, and government banks. Details are not available on all countries, but it is possible to suggest some stylized facts about mixed systems.

- These systems are typically dominated by one government-owned and three or four large foreign banks.
- All have been subject to some degree of repressive regulation but with a great deal of variation in the severity of the restrictions and enforcement.

- Many of these countries have seen the entrance of new banks and nonbank financial institutions since 1980. The increase in the number of institutions has not necessarily increased competition or expanded the range of instruments or services. Many of the new institutions are undercapitalized and may be a source of future instability.
- Most commercial banks limit risk exposure in the economy and minimize the damage of interest rate restrictions and credit allocation guidelines by focusing on fee income from foreign trade and exchange transactions rather than intermediation. The banks restrict competition by implicit or explicit collusion and provide limited service to a select clientele. The commercial banks have not been immune to pressure to lend for political as well as commercial reasons.
- These countries also have highly politicized DFIs, usually to provide term credit for "priority sectors" and seasonal credit for agriculture.
- Many of these systems have cause for concern about the stability of new, small indigenous financial institutions. In addition, some of the government banks and most of the DFIs have credit problems.

Zimbabwe, Nigeria, and Kenya are usually cited as examples of the more developed financial systems on the continent because of the number of commercial, wholesale, investment, and merchant banks, nonbank financial institutions, and leasing and insurance companies. Even with the recent increases in the number of institutions, however, most lending is still on overdraft, there are few term lending or deposit instruments, and the range of financial contracts and services available to middle and smaller enterprises and commercial agriculture is limited. Money and capital markets are poorly developed, and while all three countries have stock markets, only Zimbabwe's is fully functioning.

In Kenya and Nigeria there may be cause for concern about the stability of some institutions. Improving central bank supervision is a priority since these systems are vulnerable to the risks of new entry, innovation, and off-balance-sheet risk, as well as the risks of poorly managed financial institutions. Kenya had problems with the growth on the less-regulated fringe of new banks and nonbank financial institutions and subsequent failure of several institutions in 1985–1986. Nigeria has looming problems in some undercapitalized financial institutions. There is also concern about the recent boom in new merchant banks. Over twenty merchant banks entered in 1988, probably attracted by the foreign exchange allocated to banks.

The financial systems operating in declining economic environments are showing considerable distress. Most Mauritanian banks were technically bankrupt by the early 1980s, and this situation was compounded with illiquidity in the mid-1980s. A lengthy reform and restructuring process

finally transferred ownership of three of the banks to local private investors or foreign banks.

Ghana started financial reforms as part of a comprehensive structural adjustment program in 1983. The program used discrete adjustments to liberalize financial regulations gradually and introduced a few new instruments and institutions. The banks are now being restructured.

A few countries with troubled banking systems in declining economies have not started reforms. Sudan imposed Islamic banking in 1984. There have been no financial reforms in Sierra Leone. Uganda has undertaken only minor credit reforms.

Many of the mixed banking systems are best characterized as conservative and fairly profitable but not competitive or innovative, examples being Malawi and Botswana. Botswana is an interesting case because it has undertaken financial reforms with a fairly profitable system. The challenge for Botswana is to use significant international reserves constructively to reduce the extreme dualism in the economy, including the financial system.

Zaire and Zambia, both with volatile macroeconomic performance over the past twenty years, have fairly profitable banking systems. Both have a fair number of institutions organized as banking cartels. The banks specialize in international trade transactions with little development in intermediation services. Financial reforms in Zaire, like macroeconomic reforms, have been off and on during the 1980s.

The Zambian banks did very well under the radical economic reform program from 1985 to 1987 for several reasons. Interest rates were totally liberalized at the beginning of the reforms, and the banks quickly increased the spread between lending and deposit rates. Those spreads were maintained when interest rate restrictions were reimposed several months into the reform program. There was some interest rate competition during the reforms, but the banking cartel continued to adhere to a uniform fee schedule. The banks earned healthy fees for managing the foreign exchange accounts of exporters with foreign exchange retention privileges. It is interesting to note that the pattern of credit allocation and the client pool did not change under the reforms and continued to reflect the established pattern of conservative lending.

The franc zone countries also have mixed banking systems and will be covered in another session of this conference.

Unresolved Issues for Future Financial Policy

A host of difficult unresolved issues shadow the debate on African financial reforms. There may be agreement that perverse government intervention must be eased and the systems liberalized, but it is difficult to build a consensus on how and when and to what extent the government should disengage. There is considerable skepticism in African countries about the

future performance of uncompetitive, inefficient, potentially unstable, weak financial institutions operating in declining economies. Most governments are also not convinced that liberalizing the established banks will address the development needs of the countries, serve a broad clientele, or generate enough innovation to develop the financial systems.

Confronting these concerns about reforms is difficult when governments do not know what an optimal financial system would look like in African societies. Governments do not have an example of a well-functioning system in an African economy or even much information about the alternatives. Very few studies compare the effectiveness of different financial arrangements in Africa. The lack of information about how systems are functioning now and the alternatives make it difficult to chart a reform program that will liberalize, stabilize, and expand the range of services. Several areas of concern common across countries are outlined below as possible research topics on African financial policies.

Coordination of macroeconomic and financial reforms. It is still early for detailed analysis of the reform efforts in Africa, but there is enough information to begin work on comparative strategies used to coordinate macroeconomic and financial reforms. A host of questions will confront countries trying to liberalize. For example, it is usually argued that macroeconomic stability is a precondition for successful financial reforms, but most African countries have had recurrent bouts of inflation during structural adjustment. What does this suggest about management of interest rate policy?

Maintaining credibility in potentially unstable systems. Since countries are starting financial reform programs with many insolvent institutions, it may be difficult to retain or reestablish depositors' confidence. Some countries even face the possibility of banking panics and runs on the commercial banks, especially the countries with many new undercapitalized financial institutions. This is also a possibility with insolvent government banks. It will be at least a decade before the new systems of prudential regulation and central bank monitoring and inspection become effective. Even then better regulation and monitoring cannot prevent bank failures. How does one maintain enough credibility in these systems to prevent the erosion of depositors' confidence and, in the worst case, banking panics? It appears that Benin may become the first case in Africa where the losses of large depositors will not be fully covered by the government. Will this problem arise in other countries?

Kenya and Nigeria have started deposit insurance corporations. Deposit insurance programs are potentially very expensive, however, in countries without adequate supervision and tend to encourage rather than curtail risk taking by financial institutions. What are the alternatives to deposit insurance for dealing with potential instability in financial institutions?

Imperfections in financial markets. Governments justified past intervention because of significant imperfections in financial markets, such as missing markets and market power among financial institutions, as well as imperfections in other markets in the economy. These imperfections are still seen as significant obstacles to liberalization.

Can government policy encourage the establishment of missing markets, such as equity markets? What government policies will be needed until equity markets are functioning? What does market power in banking mean for regulation and macroeconomic policy? How much control over taxation and discretionary regulation should be left with the central bank if the banking sector does not develop more competitive behavior within a few years after liberalization? Is there a "safe" way to encourage competition? The Kenyan experience demonstrates the potential problems of encouraging competition by lowering the barriers to entry and the prudential standards for financial institutions. What are the alternatives?

Development objectives. It is easy to generalize that "development" credit programs through DFIs, or sectoral credit guidelines for commercial banks, or directed specialized credit programs are inefficient instruments of development, have distorted the financial markets, and have funded the adoption of inappropriate technology and that benefits have been very concentrated. But these generalizations provide little guidance for addressing legitimate government concerns about funding indigenous enterprises or extending service to the general population. These concerns will surface very quickly in the debate on the fate of DFIs and regulations on the involvement and exposure of commercial banks in the domestic economy.

Institutional design and financial innovation. The pressure is strong for supply-side initiatives to add delivery systems, programs, and instruments in financial markets during reform programs. It is easy to identify gaps in financial markets and draw up a list of instruments and institutions and credit programs found in Asian and Western financial markets but missing in Africa. But that list does not give much guidance on priorities or demand or viability of contracts. This means that the process of imposed institutional design is fraught with uncertainty, especially in the parts of the economy where there is little information about current practices.

Are governments worrying too much about the introduction of new contracts and institutions and worrying too little about the rules of the game for financial contracting? If governments strengthened the rules for financial contracting, would there be more endogenous financial innovation and less need for governments and donors to impose institutional design and financial market initiatives?

There are several possible explanations for why there has been so little innovation in formal financial markets in Africa. Two reasons frequently cited are lack of incentives and lack of competition. Those two factors

alone, however, cannot explain some features of structure and performance, especially missing contracts and institutions and the seeming mismatch of contract terms and enterprises funded. Unreliable and costly information and weak enforcement mechanisms are also important in explaining prevailing practices. Costly information and unpredictable enforcement mechanisms help explain why new clients have difficulty establishing credit-worthiness and why the commercial banks fund many types of enterprises with overdrafts, work only with a small group of repeat borrowers in the economy, and focus on international trade transactions.

If it is true that banking practices are driven by high transaction and information costs and weak enforcement mechanisms, then liberalizing interest rates or rewriting banking laws will help but not lead to a dramatic change in bank performance. It will be especially difficult to get innovation in areas of the economy where banks do not operate now. This suggests that governments need more information on the motivation for current banking practices and the way agents structure their financial transactions to deal with imperfect information, market imperfections, uncertain property rights, risk in the economy, screening mechanisms used under asymmetrical information, the weaknesses of the legal system and state enforcement practices for financial contracting, and the demand for different types of contracts. This information would be helpful for strengthening the incentives for endogenous financial innovation and for guiding the design of government programs and institutions, if these are considered necessary.

Summary

Many African countries have started financial reforms and are dealing with weak and insolvent institutions. The restructuring efforts are being undertaken simultaneously with reforms to establish a more flexible framework for future financial market liberalization and development. In most systems this will mean rationalizing and liberalizing the regulatory framework and more stringent prudential regulation and practices. Both the restructuring and the reregulation stages are raising difficult issues. Many governments are hesitant to disengage given the uncertainty about liberalized systems and the lack of a model for the long-term structure. The challenge for the next decade will be to find new answers and models for expanding financial services without the loss of financial discipline characteristic of past experiments. Given the difficulty of addressing the unresolved issues and the time needed to develop competition and fill out contract space through innovation, the full benefits of financial sector reforms, like the benefits of structural reforms, will take time to become evident.

25.

Stephen O'Connell

Comment

Professor Paulson has provided us with a paper that is both comprehensive and stimulating. It is rare to find a paper that succeeds in both categories.

Professor Paulson's paper does two things. First, it gives a qualitative overview of actual experience with financial sector reform in Africa. Here the experience is extremely thin so far, most reforms having gotten under way not more than five or six years ago. The review brings us up to date and provides a useful catalog of the problems that are being faced in different African countries. It also gives a good picture of the range of financial systems one finds in Africa, and Professor Paulson rightly emphasizes the difficulties of generalizing. This is one of the primary challenges that we will face at this conference: there is a need for generalization regarding financial reform for the purposes of formulating policy, but the scope for generalization, particularly in Africa, is limited by the lack of research and the diversity of the financial systems there.

The second part of the paper suggests five areas of research. Each of them is well worth our keeping in mind as we go through the rest of the conference.

I will not try to add to the admirable overview of experience, which already goes well beyond my own knowledge in this area. What I will do instead is to make some suggestions on where generalizations are likely to be found regarding the financial sector in African countries and also offer some observations about what guidance is available from academic research.

It seems to me that at least two features are deeply common to most African countries as they face financial sector reform problems. The first is that the relationship between the government and formal financial intermediaries is extremely close in most African countries. The second is the pervasiveness of informal financial markets and the potential importance of links between the formal and informal sectors.

Consider first the deep link between the government and formal financial intermediaries. This was mentioned in Millard Long's paper as well as by Professor Paulson. It has two aspects. One is that the financial sector is a source of revenues for the government in the form of the inflation tax, reserve requirements on government instruments that bear below-market rates of interest, and other means of taxation of the financial sector.

The second aspect, much more difficult to characterize and deal with, is the hand-in-glove relationship between the government and the financial intermediation sector. Political scientists and sociologists have identified many African governments as lacking legitimacy and having to maintain power by dispensing economic favors. In countries where this is the case, the financial sector is likely to be at the center of the system of patronage, serving as a conduit for capital flight, a means of distribution of economic rents through directed credit and subsidized foreign exchange, and so on.

The second common feature of African financial systems is the pervasiveness of informal financial markets. It is dismaying that we know so little about the informal sector in Africa, given that many policy questions turn on the connection between informal sector and formal financial markets. Although much of our discussion will be focused on the formal sector, we should be careful not to treat the informal sector as a temporary, contingent appendage of the formal sector.

It is tempting to talk about restructuring commercial banks so that they can start providing long-term credit for big industrial projects. But this is something they do almost nowhere in the world. It would be more appropriate to focus on enabling formal institutions to penetrate more deeply into the provision of working capital in the rural sector and in the urban informal production sector or, in the other direction, on facilitating growth and gradual formalization of successful informal sector financial institutions.

Having identified two areas where we might want to look vigorously for generalizations to guide financial sector reform in Africa, let me raise a serious question about policy priorities. Where do we place financial sector reform in the pecking order of reform requirements for African countries? I want to underscore the statement of both speakers that it is easy to overemphasize the potential of the financial sector as an engine for growth. In fact, the historical evidence in favor of a leading role for the financial

sector is extremely circumscribed. It is particularly instructive to look back at the example of Korea in the mid-1960s, since that example is at the heart of the common presumption that getting rid of financial repression will have rapid and substantial effects on growth. The fact is that the liberalization of the banking sector in Korea was implemented simultaneously with fiscal and exchange rate reforms. Both of those were capable by themselves of generating savings and increasing output. What was the independent causal role of the financial reform? If one looks back at where the Stanford school of consultants placed financial liberalization on the pecking order of issues, it turns out that they placed it clearly below fiscal reform, although they claimed that it was important.

Let me end with a number of miscellaneous comments. The most striking impression I had from Professor Paulson's paper was the pervasiveness of failures and problems in African countries. This is natural: we would not be here if the legacy were largely one of successes. It seems to me worthwhile, however, to study the successes as much as the failures. This requires a careful definition of success. As I have suggested, one's instinct is to think of success as being a great spurt of growth, a great mobilization of saving, a great increase in the quality of capital formation. This is not realistic. One thing that we do know from the experience outside Africa is that although restructuring the financial sector may not have a great causal influence on growth, inflationary finance can lead to a situation where financial intermediation becomes a strongly negative influence on growth. We therefore need to look carefully at the Botswanas, Malawis, and Zimbabwes, where major crises have been avoided, and ask what features of policy in these countries can be adopted elsewhere. The success cases have avoided systemic macroeconomic policy errors, instead of moving whole hog into completing financial markets and reforming financial institutions.

Second, regarding research, one of the things on the agenda in this conference and in Professor Paulson's paper is the question of what academic research can contribute to confronting policy problems in the financial sector. In preparing my comments, I picked up H. Chenery and T. N. Srinivasan's recent two-volume *Handbook of Development Economics* and was interested to find a chapter on information and organization of markets, a chapter on rural credit markets, and a chapter on saving and development. Conspicuously missing, given the theme of this conference, was a chapter on the macroeconomics of the financial sector or on the role of financial intermediaries in development, the kinds of issues raised by McKinnon and Shaw.

So again I find myself raising a cautionary note. The thrust of microeconomic research has been to emphasize the relative efficiency of informal credit markets in rural areas and much less to emphasize their

shortcomings. More emphasis has been placed, in fact, on regulatory failure, which is a severe potential problem in Africa. The thrust of microeconomic research has been to suggest caution and limiting the role of government. I therefore concur with Professor Paulson that the objective of policy with regard to financial innovation should be to facilitate innovation, for example by providing adequate legal structure, rather than trying to choose the form of institutions and imposing them directly.

On the macro level, the financial repression paradigm, which has found its way into nearly all the financial sector reform packages that I have seen, has a much more equivocal status in the theoretical literature.

The structuralist school, for example, has mounted a vigorous counter-attack against the policy of interest rate liberalization. If informal credit markets are relatively efficient, then raising interest rates in the formal sector may draw saving not out of consumption but out of intermediation in the informal sector. The net effect may be to lower, rather than raise, the overall supply of saving. There are other criticisms as well. On the macro end, then, we actually have less systematic guidance from academic research. As first priority for helping the financial sector, I would point to the importance of macroeconomic policy, particularly fiscal policy, in providing a sustainable, credible environment. Financial liberalization would be somewhere down the list.

As a final remark, let me suggest a comparison that has preoccupied me in thinking about the broad issue of financial reform in Africa. There has been a great deal of historical work on financial institutions in developed countries. One of the bottom lines of that work has been that the role of financial institutions in the development process depends very much on the cultural and legal milieu and is by no means automatic. There has been very little historical work on Africa, with the exception of a paper by Mundell in the early 1970s contrasting the experience of former British and French colonies. Mundell argued that the dependent role of the French monetary unions, which until 1973 had their monetary policy essentially dictated by the French, had meant gains in monetary stability but losses in monetary experience and institutional development—exactly the things we are concerned with in this conference.

The former British colonies, in contrast, formed their own central banks immediately upon independence. Mundell's view was that these countries had opted for monetary experience, gaining financial development at the expense of having to impose systems of exchange control, with all the attendant distortions. The puzzle is the following: if one looks within Africa at the growth performance of countries within the CFA (Communauté Financière Africaine) zone and outside the zone, one finds that the CFA countries have done at least as well if one makes an attempt to control for external shocks. Moreover, as we will learn later in this conference, the financial sector in the franc zone is in terrible shape. Are there any lessons

here regarding the role of institutional development in the financial sector? Will the CFA countries finally have to pay the piper for the repressed and dependent state of their formal financial markets? Or have informal markets flourished more strongly in the void created by inadequate formal sector institutions, and are the current crises in the formal sector simply a macroeconomic sideshow given the overall stability provided by the convertibility guarantees and associated monitoring of monetary policy by the French?

Discussion

Robert Porter: I have recently returned from four years of being the director of bank supervision of the Bank of Botswana. Having noticed several references to bank supervision in both Professor Long's and Professor Paulson's papers, I would add one or two practical aspects from my recent experience.

Obviously, having made a career out of it, I am a believer in the value of the American system of bank supervision, which particularly emphasizes on-site supervision: going into the various institutions, going through their loan portfolios, and gathering intelligence on their particular problems

I would like to comment on what the American style of on-site bank supervision can do, where it can help policy, and where it might not be useful. It is very, very good (this has been the U.S. experience, and I think this is true anywhere in the world) at diagnosing problems: picking up particular concerns, finding at a very early stage where problems come up. There is virtually no substitute for having a trained supervisor digging through individual loans, finding out where the problems are, and putting it together, in order to be able to come back and advise the governor of the central bank or the ministry of finance. Bank supervision often is not as good at curing problems, but at least it can inform the policy dialogue as to what is going wrong at an early stage when the clouds are building on the horizon.

Where there can be problems—from my experience in Botswana—is that African countries that have embraced bank supervision have tended to

want to use it more in institutions that might need it least. Professor Paulson commented about the former colonial banks having limited service, select clientele, and high profits and almost avoiding where possible getting involved in the real economic sector. Often when bank supervision has been introduced, those are the institutions that the bank supervisors are told to look at. Those are the ones that have virtually no chance of failure. Those are the ones that are well capitalized and well managed. Supervision is being used to some extent to go in and say, Why are they not doing more of what we want them to do, even though they are in very sound shape?

In Botswana we had a mandate to examine every institution except the single one that needed it the most. Politically sensitive development finance institutions, where loan arrears and other problems have built up, are institutions that the authorities really do not want to let the bank supervisor go into and start opening things up, because such examinations will just stir up trouble.

The value, I believe, of having active supervision, is therefore not so much that the bank supervisors are going to come up with a cure as that they are going to be able to detect the problems at a very early stage. They are going to be able to do it in detail.

My main point is that the value of American-style, on-site supervision lies in detection rather than cure. While most African countries seem to embrace the value of it, they tend at times to be misusing it. That topic may be of interest for the seminar in general.

A. B. Ndofor: I come from the Cameroon Corporate Credit Union. I would like to share my views on these issues. It is good to go back a little bit to history and see how the whole banking sector or the commercial sector, generally, developed in Africa. Africa was heavily colonized, and the early interest of the colonial masters was not commerce. At least, the colonists who operated commercial activities gave very little attention to training Africans in the various aspects of commerce and banking.

If there were accountants or bank managers, they came from France or England. After independence most African countries took a long time before the introduction of training in these fields. So today the people running the banks are typically civil servants who are trained to work in the civil service and not to work for profit or to work in commercial enterprises. The notion of control and transparency in management is thus not commonly understood. Emphasis is sometimes misplaced, as the gentleman with experience in Botswana has just said.

Rather than seeing banking reform as short-term, or partial, I think that we have to engage in complete and continuing educational policy reform. We have to examine where emphasis is laid. Many African countries still do not emphasize business training, not to mention banking. A lot of emphasis is laid on civil administration. So we find good schools training people to be civil servants, sometimes to be engineers. Later on these people do not

work in their fields but are sent either to the banking sector or to run those enterprises to which the commercial banks and the development banks are forced to lend.

They lend to people who cannot run projects, unfortunately. So my emphasis would be on improvements in the training of operators, certainly, and also training of those working in the central banks and in the ministries of finance who are charged with the responsibilities of controlling and supervising these banks.

I have found this out in a very small way through working with the credit union league. We try to control the rural credit unions, and it is a very difficult task. First, the people do not accept it. The notion of control is taken sometimes to mean distrust. It is very effective when the people themselves understand it and understand that it is not distrust but a way to enhance trust. Educating people so they can realize this would be very beneficial.

In any policy reform, therefore, we must look at the education system in the country.

Anand Chandavarkar: I had a specific point arising from the observation of Miss Paulson that one distinguishing feature of the banking system in Africa is the predominance of one large government bank and a few small or medium-scale private banks. My question is, What would happen in the event of maximum financial liberalization? This will create conditions of oligopoly, and how does one maintain competition given the institutional pattern of banking in Africa? This feature has been replicated in Asia too, and it is an extremely difficult policy issue. The experience of Malaysia and Singapore shows that conditions before and after liberalization with regard to interest rates did not differ very much. This suggests that there has been a collusive oligopoly in operation. Under these circumstances, how does one maintain competition given the political will to bring about liberalization? I will submit one suggestion: if in the event of maximum liberalization the government banks become fully autonomous but without access to taxpayers' money in the event of losses, that might help create conditions of genuine competition. My basic question is, How does one maintain competition under conditions of financial oligopolies?

Stephen O'Connell: One interpretation of how banks are able to maintain collusion is that there are entry barriers; the small number of banks would certainly suggest that this is the case. It would be important in this regard to know how much competition is provided by the informal sector: do the two sectors compete, as they did in Korea for many years, or are they effectively segmented, as seems more likely to be the case in many African countries? My instinct, however, is that the issue is exactly the one that Mr. Chandavarkar identified. The formal financial sector in many African countries is protected by exit barriers, so to speak. This suggests that some of these banks need to be able to fail, if that can be done in a way that is contained.

J. O. Sanusi: Stephen O'Connell's point that we should not overemphasize the role the financial sector can play is well taken. From where I sit, as deputy governor of the Central Bank of Nigeria, it is quite clear that it is not possible to separate the health of the financial sector from the health of the real sector because the financial sector is very much dependent on the real sector.

It is important to note in assessing loan management in the banks that a lot of macroeconomic shocks do affect the quality of loans in the financial system, which may not be anticipated at the time the loan was granted. A loan could therefore appear to be a very good loan when it is being granted, but subsequent unexpected macroeconomic shocks might occur and make it become a bad loan.

For example, in a country that has had a very drastic exchange rate adjustment, for a company that is dependent on import because of using imported raw materials or for a company that has much exposure to loans from the external sector, a lot of the projections that were made initially before the adjustment and at the time the loan was being granted become falsified.

So in our discussion for the next few days while we are thinking of the structure of the financial sector, I think we should also think of the effects of the real sector on the financial sector. Of course, we did also mention the question of priorities. We were asking whether we should stabilize first before we liberalize the financial sector. This is an issue that we also have to take into serious consideration.

For example, in the process of the adjustment of the financial sector, if we liberalize before stabilization, then of course we have a problem. And if we wait until we stabilize, we might discover that when we keep the financial sector continuously repressed, the question of stabilization also becomes very difficult.

Patrick Honohan: Two comments. The first one relates to the question of bank runs and the fragility of financial systems that has been raised. I have the impression that is not really the way things work in Africa.

The process of financial degradation in African systems is more like an engine that is running out of oil, running out of liquidity in the form of oil, and grinding to a halt. It is not having a catastrophic run, but it is working more sluggishly. People can sometimes get their money out, and sometimes they cannot.

If my model is right, then to the extent that the problems have been caused (as we have heard) by governments milking these systems—to mix the metaphor—then to refill the engine either with milk or oil is very quickly going to inhibit the learning process. What is to stop that government or another government afterward from saying: "Well this was easy; let's do it again." I think this is a reason for moving a little bit more slowly where we are not convinced that the people who have caused the problem have yet recognized that it is they who have done the damage.

Let us compensate for that a little bit by saying that I fully agree with Professor Paulson's concern when she asks what is going to provide the development role in our reformed financial systems. Isn't there really a gap in what we are coming up with? The liberalization program in practice does not seem to be enough. We sound empty and doctrinaire when we just say, remove this tax and remove this inhibition, remove this directed credit program. If we are expecting large quantities of development finance to flow from, say, Standard Chartered Bank and fill the void, we are going to wait an awfully long time. There is going to have to be something else.

We all want to liberalize the systems but not liberalize them down to a skeleton system. My own favorite hobbyhorse is the absence of equity markets, and I wonder if there is something that one should be doing on in the institutional side, whether one should be encouraging institutions, or whether that is the kiss of death to the development of equity markets.

Joshua Greene: I am going to follow up on this development question by offering a somewhat complicated comment.

The African countries I have been fortunate enough to visit are often places where there are indigenous new firms being started. I think of the little cookie factory on the main street in Lusaka, Zambia. I think of all the furniture makers that one can find on the outskirts of Kampala. If these people had been operating in the United States, they could have gone to a commercial bank and gotten a loan after giving up various types of management rights.

I bet that not one of them got much money from a commercial bank in their home country. Indeed, they probably had to go through tontines or other informal financial networks to get assistance. The question is, What can be done to try to change that framework if we believe that small firms like this operating in the private sector are an important part of development?

Having pointed that out, we should realize in what context this is happening. First, there is a tremendous history of failure among public sector financial agencies trying to get out and do similar things. Think of all the agricultural finance corporations, almost all of which, in the countries I am acquainted with, are in or near bankruptcy and needing government support.

Second, all of this, in many countries, is happening in the context of adjustment and adjustment programs that are squeezing the overall supply of credit. We want financing to go to new firms, but at the same time these countries have adjustment programs in which the overall stock in credit has to be contained within certain levels so that the countries can meet their inflation and external financing targets. Reconciling the need for money for new enterprises while meeting crop financing and government financing goals is very difficult. Part of our challenge, then, is to think of financial innovation that can work within these financing constraints.

Mohamadou Diop: I want to make a few comments on the comment concerning commercial banks and the fact that they do not finance development. What is happening today is that the reforms started in the early 1980s have forced the banks, at least in the CFA zone, which is the zone I know best, to start acting like profit-making institutions and to realize that they can disappear.

There is a perception in Africa, and here I generalize, that banks just cannot fail, that banks always have money. There is a confusion between our function as money managers and our function as enterprisers. What has been happening is that, progressively, banks have been forced to act more like real banks that can go out of money and business.

Until 1977 there were about four commercial banks in Senegal and one development bank. I would say with assurance that 80 percent of the investments in Senegal up to that date were financed by commercial banks. Why? Because most of the financings were based on a pooling of banks. The development bank may take about 20 percent as the leader of the pool, but the remaining balance would always be shared with other commercial banks.

We have to distinguish also between the colonial commercial banks and the new commercial banks, such as the Citibank group and the BCCI, which are the biggest in the franc zone area. These new banks have no problem simply because they have better trained staff and also because they have been very independent in their decision making. Self-supervision by the ownership group is important; it is focused and effective.

Until the late 1970s discipline was also effectively enforced by the ownership groups in the old commercial banks. Subsequently these groups disengaged and became minority shareholders, and most of the banks were managed by politically appointed functionaries. The group discipline tended to disappear.

As far as the central bank is concerned, I think supervision and prudential regulation of the commercial banks are somewhat adequate. What is not adequate is follow-up. Nothing happens after the central bank makes an audit or the fiscal authorities or the minister of finance makes an audit, because in the French-speaking countries regulations are shared by several agencies. This is not very well known. In addition to the central bank, there are several directors in the ministry of commerce and in the ministry of finance who also have supervisory powers, but usually really nothing happens. So I believe that market forces will be determinant in forcing not only the government regulatory agencies but also, more important, the management and the board of directors of these banks to react and to apply adequate measures.

I can offer an example that will illustrate what I am trying to say. During one meeting of my board, I had proposed a system to stop accruing interest

on nonperforming loans. The figures were very high. Among the board members was the treasury director. He started jotting down figures, and he said: "Mr. Diop, if you follow your policies and other commercial banks follow similar policies, what is going to happen is that I as the *directeur du Trésor*, am going to have a shortfall." He gave a figure, which was very important. He said: "I cannot go along with it, and my colleague, the *directeur général*, will not go along with it." So there are many considerations that come into being when a bank starts applying real banking orthodoxy, with respect either to financing development or to having adequate accounting procedures.

I would like to make one last observation. From what I have heard so far and what I have been reading in the effort being mounted to tackle the financial sector problems in Africa, it seems to me that the focus has been and remains on the commercial and development banking sector.

What I am saying may not apply to countries outside the franc zone, but in our area, in the CFA zone, I would suggest that a critical path approach or at least an institutional critical path approach be adopted. Why? Because of the considerable interdependence that exists within the public system, what I would call the public treasury, the central bank as a financial system, what we call *le compte spécial du Trésor*, special council, the treasury, the social security funds, the pension funds, the insurance companies, the postal and thrift institutions.

Why am I saying this? Because as the central bank applies very stringent credit measures to stop monetary expansion, the lack of resources makes these various institutions extremely important for the banking sector. In fact, one of the big issues to be faced is that the social security funds, the pension funds, some of the insurance companies are in danger of collapsing. Why? Because they have a lot of term deposits in some of the biggest commercial banks, especially the public sector commercial banks.

What we are seeing now is that funds from those sources are drying up, and as a result of the structural adjustment policies pursued since the early 1980s, there is a tremendous development of the informal sector. I think the real issue is going to be who is going to survive: whether the commercial banks, the financial institutions defined from a very large perspective, will survive in spite of the rapidly developing informal sector and its very dynamic informal financing systems. To a great extent, at least in a country like Senegal, these informal financial systems have been a security valve for the social effects of the structural adjustment effort.

Millard Long: I would like to come back to a few points. One of these, referred to both by Mr. Diop and by Mr. Chandavarkar, is that in many of these countries (even those with relatively small economies) there is potential for some kinds of competition with the existing financial institutions, whether it is competition from another similar financial institution, or from informal markets, or from newly emerging commercial paper

markets or bills markets (which these informal markets often become, especially if there are credit controls that prohibit the banks from offering competitive interest rates).

Perhaps we should distinguish between informal markets, which serve the very small borrower and exist because they are better at minimizing transactions costs, and curb markets, which grow up because governments are imposing credit controls and which also pose a potential for competition.

I would like to say something about the developmental aspect of these financial systems. We are making the same arguments today, about what kinds of institutional structures are most needed in the developing countries in Africa, as we were making in the 1960s. In the 1960s, while one could very well understand the path that was chosen, why many said we cannot wait for existing institutions to evolve into the kinds of institutions that will provide the kinds of financing that we want to develop, a big mistake was made. Not so much in what was done as in what was not done. There was no effort to put in place the basic financial infrastructure that was necessary: the laws, the accounting systems, and, as one gentleman has commented, training systems that would be sufficient for Africans to manage these institutions with confidence.

That was not done. Now, entering the 1990s, we are coming back, and many are again saying, the situation is not such that we can leave it to the markets or leave it to the private financial institutions. Yet the experience has been that the government institutions have not been very successful. There is around the world (less so, possibly, in Africa) a shift toward leaving more economic activities to the private sector. People are recognizing the need to get away from these government institutions that took most of their credit and allocated it not to the small potential entrepreneur who was making candy or furniture but to large public enterprises.

I think that we will see the same thing happen again, and we will still be in the same position twenty years from now, unless we put much more emphasis on building that infrastructure now. I do not know, once we start building that infrastructure, how long it will take before it is in place and we can turn away from government involvement. I am convinced that in Latin America and most of Asia the skills exist. If we just have the infrastructure, we do not need to worry about the institutions much. They will come forward on their own.

That is possibly not as true in Africa. The government may need to play the role for now of promoting institutions. But it needs to do the more basic things too. We should not just think about the immediate problem and neglect to recognize what we are failing to do in developing underlying essential conditions.

4 **Roland Tenconi**

Restructuring of the Banking System in Guinea

In a referendum held on September 28, 1958, Guinea, alone among the French colonies in West and Central Africa, rejected membership in the newly established French community and asked for immediate and total independence. Independence was formally proclaimed on October 2, 1958. France broke relations with Guinea and suspended financial and technical assistance to the country. Guinean ruler Sékou Touré then turned to the communist bloc for a model of economic development and for assistance. During an interim period, however, Guinea remained in the French franc area, and the French banks established in Guinea continued operations on a limited scale.

Guinea formally left the French franc area on February 27, 1960, with the establishment of a special monetary area (*zone monetaire speciale*), the transfer to the newly established Bank of the Republic of Guinea of the functions of the Institute of Issue of West Africa, and the issuance of a new currency, the Guinean franc, to replace the CFA franc. All the commercial banks were formally nationalized on August 11, 1960, and their functions taken over by the Bank of the Republic of Guinea, which for several months operated as both the central bank and the only commercial bank of the country. In March 1961 the Bank of the Republic of Guinea was divided into

four specialized institutions: a central bank (Banque Centrale de la République de Guinée—BCRG), an agricultural bank (Banque Nationale de Développement Agricole—BNDA), a foreign trade bank (Banque Guinéenne du Commerce Extérieur—BGCE), and a bank for trade, industry, and housing (Crédit National pour le Commerce, l'Industrie, et l'Habitat—CNCIH).

Under President Sékou Touré the Guinean economic system was based on central planning, state ownership of the means of production, and rigid state control of prices and wages. In diamond mining, for example, the two foreign companies in operation at the time of independence were nationalized in March 1961. The state enterprise that succeeded them was less than successful and halted all production in 1973. As a result of this failure, together with a decline in official agricultural exports, the bauxite (including alumina) sector became, for all practical purposes, the only official source of foreign exchange for the country apart from foreign aid.

The authorities' commitment to the Soviet model had not encompassed the bauxite and alumina sectors, which were permitted to operate autonomously under foreign management. This mining "enclave" included two joint ventures (BCG and Friguia) between the government (49 percent) and foreign shareholders (51 percent), which accounted for more than three-quarters of the production of bauxite and all the production of alumina. The other producer of bauxite (OBK) was fully owned by the state but managed by Soviet technicians. Bauxite and alumina exports accounted for more than 95 percent of Guinea's total export proceeds from the late 1970s until 1986, when their percentage of total exports dropped to 84.2 percent.

From 20 to 40 percent of total government income in the years 1982 to 1985, government revenues generated by taxes on the bauxite sector jumped to more than 80 percent in 1986 as the devaluation of the Guinean franc significantly increased the countervalue in local currency of the tax payments made in foreign exchange by the mining companies.

While the Guinean authorities left the bauxite mining sector relatively undisturbed, their attitude toward the private sector, for most of the period under review, ranged from reluctant toleration to outright hostility. By law all land was owned by the state although the private farmers and their families retained a permanent right of use of the land they were cultivating. Land users' rights could be transferred outside the family only with the approval of the local head of the party-state organization (*pouvoir révolutionnaire locale*, or PRL). After independence the government's agricultural policy was oriented toward collectivization and mechanization of production, but successive (and costly) experiments to achieve that objective met with failure. In practice the bulk of agricultural production in Guinea continued to come from small farmers who did not benefit from the government's investments in the sector but who were nonetheless

required (until April 1981) to sell a certain quantity of their production to the PRL at official producer prices. Faced with increasingly unrealistic producer prices, small farmers survived through a mixture of subsistence farming, clandestine exports (and imports) in border areas, and sales at unofficial prices on the parallel market.

At the best of times private enterprises outside the agricultural sector were considered with suspicion. From 1965 to 1979 they could not be granted any credit by the banks, and under 1964 legislation they were subject to confiscation for "illegal profiteering or enrichment." The repressive attitude of the authorities culminated in 1975 in the prohibition of all private trading, including that within village markets. The ensuing tightening of government control to prevent a shifting of the distribution of goods to the parallel market led to an increased shortage of basic goods and the widespread discontent that resulted in the so-called *révolte des ménagères* (housewives' uprising) in Conakry in 1977 and to the government's retreat from its extreme position.

Private trading was again tolerated, and the authorities somewhat loosened their grip on the economy. Starting in 1980–1981, a reappraisal of the postindependence economic policy led gradually to a retrenchment in the role of the public sector and a strengthening of the private sector. In the agricultural sector the marketing quotas were replaced in April 1981 by a development tax, and private traders were permitted to buy agricultural products from farmers and resell them to consumers. The five sectoral holding companies that grouped all public enterprises were closed. Import by private firms without purchase of foreign exchange from official sources was permitted. A privately owned commercial bank operating in accordance with Islamic law was granted a license and started operations in 1983. A few months later, in January 1984, a new government-owned bank was established to finance the activities of the private sector.

To sum up, the Guinean economic system was based on a three-tier organization. The first tier, which consisted of the bauxite sector, was able to operate without government interference and provided the country with over 95 percent of its official export revenues and over two-thirds of the total export revenues, official or not; it absorbed about one-quarter of the total imports of the country to meet its operational needs (equipment and raw material) and the needs of its work force. Its foreign exchange surpluses were transferred to the second tier, consisting of the government and public enterprises, in the form of tax or other payments. This enabled the government to pay for its expenses abroad (embassies, debt servicing, services), for official imports of material and equipment for public enterprises, and for import of basic consumer goods, which were supposed to be sold at regulated prices and were often subject to rationing.

On the export side the contribution of the government tier (including public enterprises) was negligible. The third tier consisted of the private

sector and its formal and informal (underground) components, the relative size of each component varying over time in accordance with the government attitude toward the private sector.[1] The private sector accounted for more than 25 percent of total exports ($100 million in agricultural exports and $60 million in gold and diamonds) and for perhaps half of all consumer goods imported. Transactions were generally in cash and, in some cases, in foreign exchange. The wide gap between the official and the parallel market exchange rates (1 to 6 in 1983) as well as between the regulated and the unofficial price of many goods resulted in leakage between the second and the third tiers and provided public sector officials with many opportunities for profits. An International Monetary Fund (IMF) estimate shows for 1983 an average monthly salary in the public sector equivalent to U.S.$50 (at the parallel market rate) and an average monthly income equivalent to U.S.$200, the difference coming from second jobs, income in kind, or other sources.

The orientation toward liberalization of private economic activities that Sékou Touré's government initiated in 1980 was halfhearted and expedient. By 1984 it had not gone very far as entrenched interests, bureaucratic inertia, and the weight of the regime's ideology and previous commitments, not to mention lingering fears of repression, hampered the development of the private sector and the liquidation of inefficient public enterprises. The new regime that came to power in 1984 was relatively unconstrained by ideology. The government engaged in a series of far-reaching reforms to free the Guinean economic system from pervasive state control. The reforms toward a market-oriented system included a steep adjustment of the value of the currency, the dismantlement of the system of price control, the liberalization of internal and external trade, the closing of inefficient public enterprises, and a reduction in the government and public sector work force. The rehabilitation of the banking system was an essential part of this program of reform.

Characteristics of the Guinean Banking System from 1960 to 1985

With the exception of the Islamic Bank of Guinea (Banque Islamique de Guinée—BIG), all banks in Guinea were fully owned by the government. And the BIG, established in 1983, by the end of 1985 accounted for no more than 5 percent of the total deposits and credits of the system. Most of Guinea's banks were established with a uniform initial capital of 150 million Guinean francs (equivalent to 15 million sylis after the changeover from the syli to the Guinean franc on a one GS to ten GF basis). Only the central bank and the Banque Commerciale de Guinée (BCG, established to finance the activities of the private sector), which started operations in 1984, had a higher initial capital (GS 50 million for the central bank and GS 150 million

for the BCG). The capital of the specialized banks was never increased to reflect the growth in nominal terms of their operations, so that at the time of their closing their capital represented less than one-half of 1 percent of their total assets and liabilities (Table 4.1). Moreover, the banks were prevented from building up reserves to improve their capital funds position as all their profits, reserves, and depreciation allowances were by law transferred to the government.

The banking system was highly specialized, each bank serving only a special category of customers or engaging only in a special type of operations. The BGCE (the specialized bank for foreign trade), one of the four institutional components of the Bank of the Republic of Guinea that were established in March 1961, was not allowed to accept deposits in sylis, and its operations in local currency were handled by the CNCIH on its behalf. Exactly the same requirements applied to an even more specialized offspring of the BGCE sixteen years later; the responsibility of the BNSE, established in June 1977, was for *non*commercial foreign transactions. The BNDE was formed in February 1979 by the merger of the Post Office Savings Bank and the Post Office Checking System, thus dealing exclusively with individuals and a few public entities; it was not allowed to extend credit, and its funds were invested in the form of deposits with other banks. The BGCE, the BNDA, and the CNCIH (which, with the central bank, the BCRG, were the four institutional components of the Bank of the Republic of Guinea that was established in March 1961) were supposed to extend credits exclusively to public sector enterprises. Twenty-three years later, in

TABLE 4.1

Capital and Total Assets of Guinea's Specialized Banks, June 30, 1985 (millions of Guinean francs)

Specialized bank	Capital	Total assets
Credit National pour le Commerce, l'Industrie, et l'Habitat (CNCIH)	150	366,840
Banque Guinéenne du Commerce Extérieur (BGCE)	150	211,230
Banque Nationale des Services Extérieurs (BNSE)	150	36,260
Banque Nationale de Développement Agricole (BNDA)	150	23,260
Banque Commerciale de Guinée (BCG)	1,500	20,360
Banque Nationale de Dépôts et d'Epargne (BNDE)	150	9,860
Total	2,250	667,810

SOURCE: Banque Centrale de la République de Guinée (BCRG).

January 1984, the BCG was established for dealing only with the private sector. Only the CNCIH—a bank to finance industry, domestic trade, and housing—had branches (forty of them in 1984, including five in Conakry), and the other banks had to rely on the branch network of the CNCIH for their operations outside the capital city.

The dangers of such specialization of banking and finance in Guinea were magnified, beginning in 1981, when currency issue was entrusted to a special institution under the direct authority of the head of state. The inefficiency and complication of all these arrangements were compounded by an excessive partitioning of operations and a lack of communication between institutions and between the various departments within each institution. This partitioning seems to have been intended to prevent managers from getting an overall picture of the transactions they were involved in. The lack of communications was the result of incompetence and fear and reflected the authorities' deep-seated mistrust of their citizens, including civil servants.

After the regime change in April 1984, limits on the activities of the specialized banks were abolished. Public and private enterprises were given the freedom of choosing their bank, and all banks were allowed to extend credit to the private sector. The BGCE and the BNSE were formally permitted to accept deposits in local currency, and other banks were allowed to accept foreign exchange deposits. Residents were allowed to open accounts in foreign exchange. Bank secrecy was restored, and regulations limiting cash withdrawal from deposit accounts were repealed.

The changes initiated by the new government are more fully appreciated by some recounting of how highly centralized the management of the banking system had been before April 1984. From an organizational point of view, the specialized banks were, in practice, departments of the central bank (BCRG), which approved all credit extended by the banks. Each institution was controlled by an executive committee (*comité de direction*) consisting of the governor of the central bank (or the deputy governor) and the managing director of that institution. Above the executive committee there were a High Council of Issue and Credit (Conseil Supérieur de Emission et du Credit) and a National Council of Credit. The high council was chaired by the head of state and consisted of six ministers including the governor of the central bank and was responsible for the determination of monetary and credit policy. The National Council of Credit consisted of the governor and the deputy governor of the central bank and the managing directors of the specialized banks. It had authority to review all credits in excess of 1 million sylis.

Beginning in 1976 there was also a National Conference on Banking and Insurance, which included all the senior managers of the banking and insurance system and was supposed to review periodically the activities of the banking and insurance institutions, assess their performance, and

determine their future objectives. The national conference met in 1976, 1979, and 1981, but its role was marginal; it effected no monetary and credit policy as such, and the allocation of credit was based on forecasts established by each ministerial department in the context of the Five-Year Development Plan. Government directives, through the governor or directly, were routinely approved by the National Council of Credit and implemented by the various banks. Despite the centralization of authority, or because of it, there was no coordination between the different institutions, and no serious attempt seems to have been made to reconcile book entries for operations involving more than one institution.

The specialized banks were essentially an instrument to implement the development plan and had no say in the selection of their borrowers. They extended credit to public sector enterprises on the basis of administrative decisions and in accordance with the objectives of the plan. Whereas long-term credit was mostly financed from external lines, the banks confined themselves to the financing of working capital needs of the public sector enterprises. In most cases, the government-owned enterprises required financing not only for their operating costs but for their recurrent losses as well. Credit to the private sector, prohibited in 1965, was allowed again to a certain extent after 1979, in the context of an attempted revival of the private sector, and, in 1984, a bank (BCG) was established especially for contributing to that objective. Figures available, however, indicate that credit to the private sector, including credit (technically in the form of investments) by the BIG, constituted less than 8 percent of total credit at the end of 1984 against 3 percent in 1981. Credit by specialized banks to the private sector made up about 5 percent of their total portfolio at the end of 1984.

Apart from their credit or disbursing functions, the banks were assigned the task of mobilizing savings and offering an alternative to currency holdings. To that effect all salaries above GS 3,000 (the starting salary in the civil service) were paid exclusively by checks, and government stores were compelled to deposit in their bank accounts all the proceeds of sales made against payment in currency. Interest rates paid on deposits with a maturity of six months or more seem to have been largely negative in real terms during the period, but the absence of official price indexes precludes any serious estimate of the gap between nominal interest and inflation rates. Deposits with the specialized banks represented more than half the currency in circulation in the early 1980s, but the figures should be used with caution because of the general inadequacy of the data base, the frequent and sudden fluctuations in some aggregates, and the problems of classification. For instance, the bulk of quasi-monetary liabilities did not represent deposits in the conventional sense but reflected mainly deposits of state enterprises in the form of counterpart funds or provisions against letters of credit. Deposits of the private sector seem to have constituted, to a

large extent, funds that the holders could not withdraw because of the illiquidity of the banking system.

With a staff numbering 2,348 at the end of 1984, the banking system (including the BCRG and the BIG) was largely overstaffed, as were the entire government and public enterprises sectors. This situation reflected the government's policy to provide employment to all school graduates, regardless of qualifications. In early 1985, the management of the BCRG and the CNCIH, which accounted for two-thirds of employment in the banking system, reckoned that they could cut down by half the size of their staff without any problem. The sole privately owned bank at the time (BIG) accounted only for 1.5 percent of the total employees in the sector. The absence of data makes it impossible to relate staffing levels to the volume of activity (number of accounts and of book entries, number of deposits and withdrawals) and to measure, however roughly, the productivity of the staff. The total number of accounts was estimated as 130,000, but this figure probably included a number of dormant accounts. The salary scale in the banking sector was the same as in the civil service and ranged from GS 3,000 to GS 20,000 per month, with the low end exchanging for U.S.$40, at the official rates of the time and having even lower purchasing power. Bank personnel at all levels were by and large underqualified and poorly motivated. Recruitment and promotions were heavily influenced by the perceived political reliability of the candidates and their tribal connections. There were obvious cases of nepotism and favoritism.

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

Causes for the Collapse of the Guinean Banking System

It is not easy to determine exactly the cause for the failure of the Guinean banking system. The absence of records, the inadequacies and, in some cases, adulteration of data make it difficult to follow the building up of problems and to allocate responsibilities. Table 4.5 in the Appendix to this chapter shows the evolution of the consolidated balance sheets of the specialized banks from 1982 to 1985, as they have been reconstructed from IMF reports and from information provided by the liquidation unit in the central bank. The consolidated balance sheets of the specialized banks at the time of their closure suggest that the inability of the borrowers (private and public sector enterprises) to pay their loans was only part of the

problem as public and private sector deposits exceeded by far the amount of the specialized banks' claims on both sectors. A significant portion of the deposits seem to have had their counterpart on the assets side in various unrecognized claims on other banks, which brings into question the adequacy of management and internal control in the concerned institutions. Finally, the importance of the specialized banks' liabilities to the central bank, according to the latter's books, and the huge discrepancy between those figures and the net position vis-à-vis the central bank as reported in the books of the specialized banks raise serious doubts about the efficiency of the BCRG's supervision of the banking system.

Insolvency of public and private sector enterprises. In the centrally planned economy of Guinea, banks were not expected to pass any judgment on the solvency of the borrowing state enterprises. Their role was to extend credit (short-term in principle) according to the instructions of the authorities and the specification of the development plan. At maturity the account of the borrowing firm was automatically debited, even at the cost of increasing its debit balance. When extending credit to private sector borrowers (before 1965 and after 1979), banks did not seriously assess the quality of the borrowers on the basis of objective criteria and seem to have been mainly influenced by the authorities' suggestions, personal relations, or bribes. The insolvency of most state enterprises and of many private borrowers (most of them friends of the old regime) made virtually the entire portfolio of the specialized banks unrecoverable. By the end of 1987 less than 2 percent of the banks' claims outstanding in December 1985 had been repaid (GF 181 million out of a GF 10.4 billion portfolio).

The poor quality of their portfolio, however, did not bring about the fall of the specialized banks, because of offsetting transfers from the government to the public enterprises. As required by law, public enterprises each year paid to the government accounts the entirety of their profit (if any) and depreciation allowances. The government, however, from time to time transferred funds to public enterprises to strengthen their capital funds or to wipe out their losses. For instance, the liquidation in 1981 of the five sectoral holding companies left a deficit of over GS 6 billion, which was settled by a government transfer of the same amount. Altogether the net transfer of the government, excluding tax payments, to the public sector enterprises during the 1979–1982 period averaged GS 2 billion a year. Without those transfers the net claims of the specialized banks on the public sector enterprises would have more than doubled (from GS 6.2 to GS 14 billion) between January 1979 and December 1982 (Table 4.6 in the Appendix to this chapter). Instead there was a slight improvement in the net position of the public sector enterprises (from GS 6.1 to GS 5.9 billion during the period) as well as a significant reduction in the gross claims of the banking system on the sector.

Mismanagement and fraud. The main responsibility for the failure of the banking system seems to fall on the management of the banks themselves, which permitted widespread irregularities, manipulations, and frauds. The lack of qualified staff, the absence of any system of internal control and of reconciliation of book entries, the excessive partitioning of operations, and the lack of communications between departments and institutions resulted in confused and disordered accounting practices. Items were not entered in the books or were entered with considerable delays. Financial statements were not prepared or, when prepared, were often adulterated. Participation in various schemes to take advantage of the accounting chaos was widespread and seems to have involved staff members of the banking system at all levels as well as their friends and allies in the public and private sectors.

In view of the disorganization of the accounting system, the frauds did not require sophisticated manipulations. Fake or altered documents and forged entries in the books seem to have been used equally and with similar results. Depositing for immediate credit a certified check drawn on another bank was a most favored means of boosting an account balance. As a result of these various actions, the assets of the banks increasingly included claims on other banks or on the central bank, which were not recognized by the alleged debtors. Those fictitious assets amounted to about GF 30 billion at the end of 1984 and included a difference of GF 12 billion in the net claims of the central bank on the specialized banks, as reported in their books, a GF 5 billion discrepancy between the reciprocal claims between specialized banks, and a gap of GF 13 billion in the interbranch account (*compte de liaison*) of the CNCIH. By the time of their closure on December 22, 1985, the fictitious assets of the state banks had jumped to about GF 40 billion—approximately 80 percent of their total assets—including GF 4.5 billion in certified checks issued after July 26, 1985, when the practice was prohibited (see Table 4.5 in the Appendix to this chapter).

Supervision of the banking system. It is difficult to understand the role that the central bank played in the failing of the banking system. The organization of the system gave the central bank a decisive say in the working of the state banks. Its governor, who enjoyed ministerial rank in the cabinet, was the chairman of the executive committee of each bank. An Inspection Department in the central bank was responsible for the supervision of the banking system, and its inspectors were supposed to make, and indeed did make, on-site inspections. Nothing much, however, seems to have come out of these inspections except in some cases the conviction of bank officials or staff who were no longer in political favor. On the whole it seems that the central bank turned a blind eye on highly questionable practices either on grounds of self-interest or in order not to upset the

delicate balance of political power within the system. The central bank apparently chose to ignore the blatant and growing discrepancy in the amount of its claims on state banks according to its books and the banks' books. Moreover, its decision in 1981 to end all clearinghouse operations suggests that conflicting interbank claims were already getting out of hand by that time.

The central bank, for reasons ranging from an underestimate of the crisis to the fear of losing face or worse, was unable to tackle the problem and resorted to various expediencies to help the banking system survive. Efforts to increase the resources of the banks and prevent loss of cash included the mandatory payment by check of all salaries in excess of GS 3,000 a month and a GS 20,000 ceiling on monthly cash withdrawals from a bank account. Recalls of currency notes seem also to have been a favorite device to reduce the share of currency in the money supply (and also to detect hoarding and other antisocialist behavior). In the last currency recall under the old regime in April 1981, exchange for new notes was limited to a maximum of GS 20,000, with any amount in excess deposited with the banking system. A few months later, in August 1981 and June 1982, respectively, the GS 500 and GS 100 notes were withdrawn from circulation and their amounts credited to bank accounts.[2]

The exchange operations seem to have been used for inflationary finance, as the amount of new notes they put in circulation significantly exceeded the amount of notes presented for exchange, especially in April 1981, when the exchange operation was entrusted to the party organization.[3] The infusion might have eased somewhat the hardship of depositing part of the notes with the banking system and possibly increased the amounts credited to bank accounts. As mentioned earlier, the authorities also helped the banking system, through infusions of cash, reduce the indebtedness of the public enterprises (Table 4.6 in the Appendix). Even if the taxes paid by the public sector enterprises are taken into consideration, the net transfers of the government to those enterprises amounted to GS 2.8 billion in 1982. There seems to have been, however, a growing feeling in government circles that all those measures were more a palliative than a cure and that the timid reorientation of the economy toward a more market-oriented system as well as the closing of a number of inefficient public enterprises was not sufficient. In the last year of his life President Sékou Touré had requested and obtained from France the secondment of a senior financial adviser, and negotiations were under way with the IMF about technical assistance in the banking field.

Closing and Liquidation of the Specialized Banks

The new regime inherited a disastrous situation. If anything, the changeover to a new government tended to make matters worse in the

banking system. The possibilities for the banks to engage in operations previously prohibited because of their specialization, the liberalization of internal and external trade, and the return of a number of refugees increased the opportunities for profitable manipulations and frauds, while the subsiding fear of harsh repression made many operators bolder. The fictitious assets in the accounts of the specialized banks increased significantly in 1984 and in 1985. The use of certified checks to inflate deposit balances spread out of control. The prohibition of the practice in July 1985 was to no avail, and certified checks issued after July 1985 constituted close to one-third of the private sector deposits on December 22, 1985.

Although the rehabilitation of the banking system was high on the agenda of reform of the new government, things moved slowly at first. Banking legislation, first discussed with the IMF in October 1984, was enacted in March 1985. Among other things it opened the possibility for non-Guineans to manage a bank, subject to prior approval by the authorities. It included no provision, however, regarding bank supervision and prudential ratios. New central bank legislation was enacted in September 1985, which transferred to the central bank the privilege of currency issue. The first technical assistance experts, including a general adviser who was shortly afterward appointed deputy governor of the central bank, reported for duty in the spring of 1985. A technical assistance mission of the IMF visited Conakry in March 1985 to report on the situation of the banking system and offer suggestions for its rehabilitation. A consulting firm, financed by the World Bank, was hired to assist the government in restructuring the banking system, and several consultants visited Conakry to that effect in October and November 1985.

Early in 1985 the government had begun negotiations with several French banks to establish new banks in Guinea under foreign management. The first bank (Banque Internationale pour l'Afrique et Guinée—BIAG) started operations in August 1985, with a 51 percent participation of the government in the capital. The second bank (Société Générale de la Banque de Guinée—SGBG) opened its doors in December 1985 as a privately owned institution, with 55 percent of the capital subscribed by private Guinean investors. The third bank (Banque Internationale pour l'Industrie et le Commerce de Guinée—BICIGUI) started operations in January 1986 with an initial 51 percent participation of the government.

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

other state banks. The interbranch account of the CNCIH alone accounted for about one-third of the fictitious assets of the whole banking system. The operations of the CNCIH on behalf of the treasury outside Conakry involved mainly the payment of the salaries of public sector employees. It was possible to transfer those functions to the provincial authorities as long as the Ministry of Finance and the central bank were able to ship the needed cash to the provinces. The authorities, however, had given up any hope of saving the CNCIH when the prospective foreign banks, which were prepared to set up affiliates in Guinea, refused adamantly to take over any of the existing banks, even if their assets and liabilities were clearly segregated and guaranteed by the government. The state banks had nothing to offer, not even physical facilities. But the negative attitudes of the new banks reflected primarily their desire to follow their own personnel policy and staff selection and to start operations without the burden of the excessive and underqualified staff of the existing institutions. Other arguments against the closing of all banks, such as the interest of their depositors and the needs of businessmen, were easily dismissed as most deposit balances were frozen anyway and businessmen could, since August 1985, rely on a newly established foreign bank (and since December 1985 on a second one).

On December 22, 1985, the president of the republic announced the immediate closing of all the state banks and their liquidation under the supervision of the central bank. The BIG, which was in almost as difficult a situation as the state banks, was left to its own devices, as it was privately owned and of marginal importance. The central bank was reorganized and started its operations in 1986 with a fresh balance sheet including only items whose existence had been verified and confirmed.

The liquidation of the specialized banks was entrusted to a Liquidation Committee consisting of three members representing the central bank, the Planning Ministry, and the Ministry for Economy and Finance under the general supervision of the central bank. The principal tasks of the committee were, with the assistance of a foreign consulting firm, to identify the net claims of the banking system on public and private borrowers and the "true" deposits of the public with the banking system, to "clean up" the interbank accounts, including those involving the BCRG and the interbranch accounts of the CNCIH, and finally to make an estimate of the fixed assets of the banks. These were not easy tasks. Many documents were missing, and some documents, particularly those that appeared at a later date, were of dubious validity. Decisions on the validity of claims were unavoidably subjective and arbitrary in many instances. Principles and guidelines established beforehand were not always strictly adhered to.

A special liquidation unit was set up in the central bank under the direct authority of the general controller of the bank to implement the decisions of the committee and keep the accounts of the liquidation

operations. With the passage of time the governor of the central bank and the liquidation unit gradually took over the responsibilities of the committee, which met for the last time in 1987. The staff of the closed banks were placed in "*situation de disponibilité*," which meant that they were available for transfer to other parts of the civil service or for hiring by the private sector. In the meantime they continued to be paid by the government and became part of the more general problem of redundancies in the public sector. Some of them were hired by the new banks.

The initial and most important task of the Liquidation Committee was to verify depositors' claims on the banks. The operation involved (1) the adjustment of the deposit balances after cancellations of all "certified" checks drawn after July 26, 1985, and credited to the account of a depositor and (2) the verification of depositors' claims that had not been entered or had been entered inaccurately in the books of the banks. The first operation, the reduction of balances (the so-called refection), was completed within a few months in 1986, but complaints were heard long afterward (in a number of cases the canceled checks were debited to the wrong accounts). The verification of the claims held by depositors was still going on in January 1989, resulting in additional increases in the amount of deposits to be reimbursed.

The failure of the authorities to set up a deadline for the registration of claims on banks by alleged depositors, and also for their disposition, was a major flaw. It cost the government and is still costing it hundreds of millions of Guinean francs. The second flaw in the adjustment and verification methods was the exclusion of public sector enterprises from the operation of refection, on the grounds that all public enterprises' claims on banks were to be canceled outright, the government allocating funds on a selective and direct basis to the enterprises that were continuing their operations. In fact, there were so many exceptions to that general rule that in 1986 reimbursement of public sector deposits exceeded reimbursements to the private sector. For the entire period through September 1987, repayments to the public sector constituted 41.7 percent of their claims, recorded as of December 22, 1985. Repayment to the private sector constituted the same percentage (41.8 percent) of its claims (recorded at the same date, December 22, 1985, before refection).

At the time of their closing, the cumulative losses of the state banks were roughly equivalent to the total of the depositors and the BCRG's claims on those banks. There was hardly anything of value on the assets side, except for the balances in correspondent accounts. Banks did not have any fixed assets (land and buildings belonged to the state). The sale of their equipment and supplies yielded less than GF 6 million (equivalent to less than U.S.$20,000 at the 1986 exchange rate), and the rate of recovery on their loan portfolio was still below 3 percent almost three years after the closing of the banks. At the end of July 1988, after reimbursement to

correspondents, sales of assets amounted to about GF 1.8 billion, of which cash in vault and loans repayments made up GF 0.1 and GF 0.3 billion respectively. Correspondents (net) accounted for GF 1.4 billion.

Table 4.7 in the Appendix shows the evolution of the total claims (excluding correspondents) between December 1985 and September 1987 as expressed in Guinean francs and an estimate of their value in U.S. dollars. The progression of change in the total amount of the claims (in GF) is the result of the adjustment of the claims expressed in foreign exchange to reflect the depreciation of the Guinean franc and the acceptance of claims that were not included in the consolidated balance sheet on December 22, 1985. Those claims (including reimbursements) constituted about 7 percent of the estimated 1987 gross domestic product at market prices.

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

- Balances in individual accounts not exceeding GF 500,000 were reimbursed in full.
- Balances in individual accounts exceeding GF 500,000 could be used to pay for the purchase of agricultural inputs and equipment (when available) from public sector enterprises or to pay customs duties.
- The net claims of the public sector enterprises were canceled, as it had been decided that the government would allocate to those enterprises still in operation such amounts of funds as were needed for their activities.

In practice, however, the option given the account holders to pay for agricultural inputs and equipment was discontinued in 1987, because of the widespread use of fictitious invoices. The rule providing for the cancellation of all claims by public sector enterprises was not fully applied. Balances in excess of GF 500,000 were also reimbursed in special cases to relieve "depositors' hardships." It is also difficult to understand why significant amounts representing balances of less than GF 500,000 were still being repaid in 1987 and 1988, since those claims should have been settled by priority in 1986.

Total reimbursements amounted to GF 12.0 billion by the end of 1987. According to the liquidation unit, remaining claims for reimbursement totaled GF 9.9 billion on that same date. Repayments in the first seven months of 1988 amounted to GF 1.5 billion, but claims outstanding at the end of 1987 had not been reduced by the same amount. There had been further adjustments of claims denominated in foreign exchanges on account of the depreciation of the local currency since January 1, 1988, and new claims had been verified and registered since then.

Reimbursement of balances between GF 500,000 and GF 1 million commenced in 1988. During that year, the central bank and the Ministry of

Finance also agreed to settle all the remaining valid claims through the issuance of interest-bearing treasury bonds. Interest in implementing such an operation, however, seemed to die down quickly, and it is clear that the proposal did not elicit much enthusiasm in either agency. The Ministry of Finance did not see much point in paying interest on bonds, which the central bank would eventually issue money to repay, rather than reimbursing the claims gradually and directly with newly issued central bank money advanced to the government at zero interest. The central bank's argument that the repayment of the bonds would generate more rapid inflation is valid only to the extent that the pace of the bond repayment would exceed the expected disbursement of funds under the established system of settlement.

The settlement of the deposit claims on the state banks was financed initially, in 1986, by a government allocation of GF 4.5 billion, which required an equivalent increase in central bank advances to the government; by an initial realization of GF 1.8 billion in state banks assets after netting the reciprocal claims between the banks and their correspondents; and by direct advance of GF 2.5 billion from the central bank for repayment of claims in excess of the initial allocation from the government and the proceeds from the sale of bank assets.

The liquidation of the state banks was a costly operation, financed essentially by money creation (an increase in central bank liabilities) and consequently a source of increased inflationary pressure. Reimbursements to the private sector and the public sector enterprises, at the end of July 1988, were roughly equivalent to 15 percent of the money supply on that date. The total cost of the liquidation of the state banks that will be charged to the government will exceed GF 40 billion (20.6 for BCRG claims, 10.6 in net reimbursements before July 1988, and approximately 10.0 thereafter).

To this cost should be added various miscellaneous expenses, including the amounts paid to the consulting firms that assisted the authorities in verifying claims and sorting out the accounting mess (between U.S.$3 million and U.S.$4 million), the cost of the liquidation that was not charged to the banks being liquidated and was borne by the central bank, and the cost of the salaries of the banks' staff for an interim period. Taking everything into account, the total cost of the liquidation may well reach GF 45 billion or close to U.S.$100 million at the coterminous exchange rate.

The New Guinean Banking System

The establishment of new banks in Guinea was part of a vast economic and monetary reform program that included a currency changeover from the syli to the Guinean franc, a twelvefold devaluation of the local currency, the liberalization of imports and agricultural exports, the gradual abolition of price controls, and the establishment of a foreign exchange auction market.

One of the three new commercial banks, the BIAG, started operations in August 1985 before the closing of the specialized banks. Two other commercial banks—the SGBG and the BICIGUI—were established soon thereafter, in December 1985 and January 1986, respectively.

The only privately owned bank in existence in Guinea before 1985, the BIG, established in August 1983, continued operations but required a significant infusion of new capital funds to offset accumulated but unrecognized losses. At the end of 1986 the total assets and liabilities of the BIG made up 17 percent of the totals in the Guinean banking system. By June 1988 its share had declined to 9 percent. Moreover, the BIG balance sheet was inflated by the values at which it carried its nonperforming investments, which amounted to over two-thirds of its total portfolio. The bank insisted that it was still expecting to recover up to 75 percent of those nonperforming investments. At the end of 1987 the BIG for the first time allocated a substantial portion of its profits to provisions against bad loans.

The new banking system as a joint venture between the government and foreign banks. The three new commercial banks were established with foreign participation in their capital and under foreign management. The Guinean government took an initial 51 percent participation in the share capital of the BIAG and the BICIGUI. The balance of BIAG shares is held by the Banque Internationale pour l'Afrique de l'Ouest (BIAO) and by the Société Internationale pour le Financement et le Développement en Afrique (SIFDA). The balance of BICIGUI shares is held by the Banque Nationale de Paris (BNP), three international or national financial assistance agencies (including the International Finance Corporation), the European Investment Bank, and the Société Financière pour les Pays d'Outremer. The government participation in the BICIGUI has been reduced to 39.5 percent as a result of a capital increase, but the government retains the option to regain its previous majority control through subscription to a special capital increase. The shares of the third bank (SGBG) are divided between the Société Générale (SG) of France at 45 percent and private Guinean investors at 55 percent. The three banks are managed by French banks (BIAO, BNP, and SG, respectively), and expatriates make up about 7 percent of their total staff (see Table 4.3).

The banks are adequately capitalized. Capital funds of the commercial banks amounted to GF 8.6 billion at the end of June 1988 and were equivalent to about 10 percent of the total assets and liabilities of the banking system (Table 4.2).

The Guinean authorities had no other choice but to turn to foreign banks to revive the banking system. The old state banks were in such a state of disrepute that the public would not have trusted any local institution that could be associated, however remotely, with those banks. Qualified managers were not available locally, whereas foreign (French) banks were

TABLE 4.2
Ratio of Capital Funds in the Banking System, December 1986 to June 1988 (end of period)

Capital funds as a percentage of	Dec. 1986	Dec. 1987	June 1988
Total assets	13.3	11.1	9.6
Deposits	21.4	19.3	15.6
Credits	43.0	27.9	22.6

SOURCE: Commercial banks.

thought to have sufficient human resources and experience in the area to be able to assemble a management team for a Guinean subsidiary rapidly. Foreign banks could also provide capital, which at the time was scarce locally, although the SGBG was able to attract private investors (most of whom had just returned from abroad). The government participation in the capital of two of the new banks reflected the perceived scarcity of local capital as much as it represented a concession to the nostalgic partisans of state ownership of "sensitive" enterprises. The government so far seems to have made no attempt to use its participation to influence banks' business decisions, but the BIAG and the BICIGUI began claiming in 1988 that they should have a monopoly in managing the funds of the public sector enterprises because of the government's participation in their ownership. It would probably have been better to provide from the start for a rapid disengagement of the state and a sale of its bank shares to local interests at the first opportunity.

In view of the conditions prevailing in Guinea, foreign banks were somewhat reluctant to answer the invitation of the authorities to set up business in Guinea. Various incentives were included in the specific agreement that each bank concluded with the government before its installation. A similar agreement had been concluded before 1984 between the government and the BIG. Each of the new banks was granted extensive tax holidays for periods of three to fifteen years (applicable to the institution, its shareholders, and its expatriate staff) and the right to hold its capital in foreign exchange abroad. One bank was given the option to keep its account in foreign exchange. Another was guaranteed another 20 percent of all foreign trade operations and given the right to deduct from its taxable profits after the end of its period of tax holidays the amount of the depreciation allowances made during that period. In one case a bank was exempted in advance of any penalty it could incur for noncompliance with reserve requirements. While some of the provisions may have implicitly been permitted to lapse, the advantages extracted by the banks are now a source of resentment for the authorities and, gradually, for the

more general public. Critics, of course, tend to be forgetful of the difficult conditions under which the new banks started operations in 1985. At the same time some of the provisions of the agreements border on the petty and may not be worth the ill will they have generated.

Favorable business conditions for banks in Guinea. Despite the widespread mistrust in the banking system, the appalling physical facilities, the absence of communications with the external world, and the poor qualifications and motivation of the local staff, business conditions for the new banks in Guinea were favorable from the start on some important grounds. First, the banks were free of any government interference in their operations. There was no attempt by the authorities to direct credit toward "privileged" borrowers or the government. The banks' recruitment policies were free of any government intervention, and in practice there was no limit on the hiring of expatriates (there was only a 15 percent ceiling in the government agreements with the BICIGUI and the SGBG). Banks were allowed to import free of custom duties equipment and supplies needed for their operations and the housing of their staff. Credit control and supervision by the central bank were minimal. Banks were not subject to reserve requirements or to prudential ratios. Interest rates charged on loans or paid on deposits were not regulated until September 1986 and January 1987, respectively. Maximum lending rates were negative in real terms even after being increased significantly in January 1987 and February 1988, but enforcement of those rates did not seem to rank high in the priority list of the central bank.

In January 1989 interest rates remained free on demand deposits and time deposits with a maturity of less than six months. The spread between minimum deposit rates and maximum lending rates was comfortable (from eight percentage points for time deposits with six- to twelve-month maturity to thirteen percentage points for savings deposits), and the methods of computing interest rates on time and savings deposits tended to reduce the effective rate paid on those deposits. Commissions were unregulated until February 1988. Banks were allowed to open accounts in foreign exchange for nonresidents and residents alike, subject to some quite liberal conditions for the residents. Banks were also permitted to invest their liquid funds abroad with their correspondents even for the portion of those funds that exceeded their foreign exchange risk exposure, which means they were permitted to speculate against the Guinean franc at a time when the depreciation of the local currency was a certainty.

The main advantages the new banks enjoyed, however, was related to the negligible cost of their deposits. For all practical purposes currency holdings and bank deposits were (and still are) the only financial assets in Guinea. The government has issued no securities, and shareholding in a few private or mixed sector companies including the banks themselves is minimal. For a while, after the closing of the state banks in 1985, financial

assets consisted almost exclusively of currency. At the end of January 1986 deposits in Guinean francs with the commercial banks amounted to GF 1.6 billion and constituted only 6 percent of the total money supply. The liberalization of internal and external trade, the opening of a foreign exchange auction market, and in general the return of some normalcy in business transactions promoted the buildup of deposit balances. The impressive growth of deposits since 1986 has exceeded expectations. Deposits account now for over 25 percent of the total money supply.

Comparison with other countries in the area suggests that there is still ample room for further increases in the ratio of deposits to money supply. Banks have felt that the deposit market was to a large extent a captive market and there was no need to pay interest on deposits. Their rapidly expanding deposit base enabled banks to neglect their relative share of the market and weakened their competitive spirit. As a result the average remuneration of deposits ranged from 0.3 to 1.0 percent in 1987, depending on the bank. Initially deposits were mainly in foreign exchange, and it is only since February 1987 that deposit balances in Guinean francs have exceeded deposit balances in foreign exchange.[9]

Profitability of the banking system. The profit-and-loss statements of the commercial banks for 1987 (Table 4.8 in the Appendix) provide a bottom-line version of the business conditions described above. Total operating income for the entire system was 18 percent of the average banking assets (16.5 percent of average total assets). Net operating income amounted to over 7 percent of average banking assets (6.7 percent of average total assets) and close to 50 percent of the capital funds. Net profits, after depreciation and loan-loss provisions, were 0.55 percent of average total assets and 4 percent of total capital.

The most profitable of the four commercial banks (SGBG) had net profits, after depreciation and loan-loss provisions, that were 4.1 percent of its average total assets and 39.8 percent of its capital (Table 4.9 in the Appendix). The large spread between the average cost of deposit (0.6 percent) and the average interest rate charged on loans (19.4 percent) and the size of the various commissions charged by the banks (7.5 percent of average total assets) explains these favorable results despite considerable overheads linked to the initial starting cost of business and the cost of expatriate staff. Overheads made up 8.6 percent of average total assets in 1987. Furthermore, the net income of the banking system before depreciation and provisions may have been somewhat understated, for instance, because of the automatic reevaluation of the capital (partially offset in some cases by a parallel revaluation of fixed assets), the undervaluation of some assets, and the overvaluation of services rendered by the head office.

The interest margins of the banking system, which seem excessively wide, enabled the banks to finance their initial cost and (for the BICIGUI

and to a lesser extent the SGBG) the development of their branch networks. Depreciation allowances amounted to over GF 650 million and close to 15 percent of the fixed assets and participation of the banking system at year's end. Wide margins also paid for the high personnel expenses of the banks, which in 1987 ranged from 2.1 percent (for the BIG) to 4.5 percent (for the BICIGUI) of average total assets (see Table 4.3). The average cost per staff member in Table 4.3 is understated because it is based on the total number of staff members in January 1988 whereas the average number of staff during 1987 was less than that for each of the banks with the exception of the BIG. Expatriate staff account for about 7 percent of the total number of staff and for over 50 percent of the total cost of the staff.

Finally, wide interest margins also enabled the banks to build up adequate provisions against doubtful loans. Provisions for the 1987 financial year amounted to GF 2.9 billion and accounted for over 10 percent of the total credit outstanding at the end of the year and 13.7 percent of the average credit during the year. The difference among the banks in their provisions for bad loans is evident in Table 4.4.

The poor quality of the banks' portfolios, as suggested by the importance of the provisions, may be attributed to the recent establishment of the banks, their insufficient knowledge of credit conditions in Guinea, the absence of previous credit records of their borrowers, and in some instances inadequate portfolio management. It may also be related to difficulties in securing loans with proper collateral and in achieving foreclosures. Notwithstanding those explanations, the poor quality of the banking system's loan portfolio is a cause for worry, especially since the banks have been operating with a larger expatriate staff than in many

TABLE 4.3

Size and Cost of Staff in the Banking System, 1987

	BIG	BIAG	BICIGUI	SGBG	Total
Total staff	50	84	268	130	532
Expatriate staff	5	7	18	8	38
Cost per staff member (GF million)[a]	2.9	4.3	3.4	4.5	3.8
Staff cost as a percentage of:					
Average deposits	7.6	3.8	7.2	7.6	6.3
Average credits	4.2	14.6	12.4	9.2	10.2
Average total assets	2.1	3.0	4.5	4.0	3.7
Total overhead	45.0	31.1	46.7	48.0	43.0

a. At U.S.$1 = GF 420.

SOURCE: Commercial banks.

TABLE 4.4
Provisions against Bad Loans, 1987

As a percentage of:	BIG	BIAG	BICIGUI	SGBG	Total
Credit at year end	2.7	7.7	18.7	5.6	10.0
Average credit	3.6	10.9	23.3	8.4	13.7
Average assets	1.8	2.3	6.9	3.6	5.0

SOURCE: Commercial banks.

countries in the area and have been immune from any government pressure in their loan policy.

The BIAG and the BICIGUI reject vehemently any suggestion that their provision policy might have been influenced by a desire to hide excessive profits or, in the case of the BICIGUI, to show clearly the cost associated with the implementation of its branch network. The case of the SGBG is different, as pressure by local shareholders might have resulted in lower provisions than called for by the portfolio situation. The provisions proposed by the SGBG in an initial version of its profit-and-loss statement for 1987 (as certified by the auditors) were halved in a second version, possibly to increase net profit significantly and thereby to justify the payment of a comfortable dividend. All banks now insist that the quality of their portfolios is a serious problem and that they have taken steps to correct the situation through a review of their loan procedure and a tightening of internal controls. They also seem anxious to pursue this buildup of their provisions to clean up their portfolios. The preliminary profit-and-loss statements for the SGBG for the first six months of 1988 showed provisions for the semester almost equivalent to the provisions for the entire previous year. The BICIGUI announced a similar policy. The problem is probably less severe for the BIAG. The central bank could help to define prudential rules for banks and to develop guidelines for the accounting treatment of nonperforming loans.

The Future of the Banking System

The determination of the banks to clean up their portfolios comes at the right time, as their profit position may gradually deteriorate in the future. The honeymoon period with the authorities is clearly over, and banks may soon have to give up some of the advantages provided by their agreements with the authorities. The regulation holiday is also over. Banks have already been compelled, since February 1988, to reduce their commissions. Prudential ratios as well as reserve requirements may be anticipated in a not too distant future. The authorities may be expected to urge

the banks to promote savings more actively and to improve remuneration of savings deposits. And, indeed, the cost of deposits doubled in the first half of 1988 and was expected to double again in the second semester.

The increased competition among banks, as a result of the slowing down of the growth rate of deposits and the establishment of a new bank at the end of 1988, is bound to put additional pressure on bank margins. A more thorough screening of borrowers and the search for safer credit opportunities are bound to stimulate competition to attract the best-rated clients. The spread between the average cost of deposits and the average charge on credit might come down by at least two percentage points in 1989, from 18.5 to 16.0. This combined with lower commissions might reduce the gross operating income of the banking systems from 16.5 percent of total assets in 1987 to 15.0 percent in 1988 and 14.0 percent in 1989. At the same time additional interest paid to depositors may add one percentage point (in relation to total assets) to the cost of funds in 1988 and another percentage point in 1989. Should the overheads remain at the same relative level, net operating incomes would be cut by two-thirds in 1989 and would constitute only 2 percent of total assets. This would be insufficient to provide for reasonable depreciation allowances and provisions and leave adequate net profits.

Accordingly, the future health of the banking system seems to hinge on the ability of the banks to reduce their overheads. Medium-term prospects in that respect are mixed. Initial costs associated with the establishment of new banks should decrease somewhat. The gradual replacement of some expatriates by local staff should generate savings, but those might be offset by improvements in the remuneration of the local staff (their remuneration went up by 80 percent in 1988). In the final analysis, it seems that the future profitability of the banking system will depend on the capacity of the banks to keep the growth rate of their overheads below the rate of expansion of their deposits (or assets).

TABLE 4.5

Consolidated Balance Sheets of Guinea's Specialized Banks, 1982–1985, by Date of Issuance (billions of Guinean francs)

				12/22/85		
	12/31/82	12/31/84	9/30/85	A	B	C
Assets						
Cash	0.1	0.1	0.1	0.1	0.1	0.1
Correspondents	0.9	n.a.	0.5	0.2	0.2	2.5
Public sector claims	10.5	7.5	8.8	8.9	8.9	9.3
Private sector claims	0.4	0.4	1.8	1.5	1.5	1.5
Other assets	1.4	0.0	0.1	0.1	0.1	0.1
Fictitious assets	7.6	18.1	16.2	39.4	34.9	42.4
Claims on specialized banks (net)	n.a.	(4.7)	(6.9)	n.a.	n.a.	n.a.
Interbranch accounts	n.a.	(13.4)	(3.3)	n.a.	n.a.	n.a.
ACRG	n.a.	n.a.	n.a.	(15.0)	(15.0)	(15.0)
Assets = liabilities	20.9	26.1	27.5	50.2	45.7	56.0
Liabilities						
Correspondents	1.5	n.a.	1.1	0.9	0.9	3.5
Public sector deposits	7.1	7.1	9.8	11.5	11.5	31.9
Private sector deposits	4.0	6.0	8.3	14.8	10.3	n.a.
BCRG	8.0	4.4	5.4	20.6	20.6	20.6
Other liabilities	0.3	8.6	2.9	2.4	2.4	n.a.

NOTES: n.a. = not available.

1. In the earlier three balance sheets, the position of the specialized banks with respect to BCRG is net and appears only on the liabilities side. It differs significantly (by about GF 12 billion at the end of 1984) from the net position as reflected in the BCRGs books.

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

3. In the B version of the December 22, 1985, balance sheet, the deposits of the private sector have been adjusted to reflect the cancellation of the certified checks drawn after July 26, 1985, and credited to private sector accounts (an operation prohibited since July 26, 1985).

4. The C version is derived from the B version, but some of the assets and liabilities in foreign exchange have been adjusted to reflect the new exchange rate established on October 7, 1985, for certain transactions (FF 1 = GS 36 instead of SDR 1 = GS 24.68, approximately a 30 percent devaluation).

SOURCES: IMF SM 83-167 (Balance Sheet 12/31/82); IMF Technical Assistance Report of March 11, 1986 (Balance Sheet 12/31/84); Development Finance Consultants' Report of December 26, 1985 (Balance Sheet 9/30/85); Liquidation Unit at BCRG on the basis of Development Finance Consultants' Report (Balance Sheet 12/22/85, A, B, and C).

TABLE 4.6

Specialized Banks' Claims on Public Enterprises and Financial Flows between the Government and Those Public Enterprises, Excluding Tax Payments, 1978–1982 (end of period, billions of Guinean francs)

	1978	1979	1980	1981	1982
Claims on public enterprises	11.4	5.9	14.6	15.5	10.5
Deposits of public enterprises	5.3	4.3	6.9	7.1	4.6
Net claims	6.1	1.6	7.7	8.4	5.9
Profits and depreciation allowances paid to the government		3.3	1.6	4.0	5.4
Transfers from goverment		7.9	n.a.	3.0	11.5
Net transfers from government					
During the year		4.6	−1.6	−1.0	6.1
Cumulative since January 1, 1979		4.6	3.0	2.0	8.1
Net claims on public enterprises including transfers from government		6.2	10.7	10.6	14.0

NOTE: n.a. = not available.

SOURCE: Data provided by Guinean authorities as reported in IMF SM/83/167.

TABLE 4.7

Claims of the BCRG and Depositors on State Banks, 1985–1987 (billions of Guinean francs)

	December 22, 1985			September 30, 1987
	A[a]	B[b]	C[c]	
1. BCRG claims on state banks	20.6	20.6	20.6	20.6
2. Deposits	26.3	21.8	31.9	26.9
Private sector	11.8	10.3	n.a.	11.6
Public sector	11.5	11.5	n.a.	15.3
3. Total (1+2)	46.9	42.4	52.5	47.5
equivalent $ (millions)	1876.0	1696.0	181.0	108.0
4. Reimbursements				11.2
1986				(8.6)
1987 (9 months)[d]				(2.6)
Equivalent $ (millions)				29.0
1986 ($1 = GF 350)				(24.0)
1987 ($1 = GF 420)				(5.0)
Total (3+4) in GF	46.9	42.4	52.5	58.7
in dollars	1876.0	1696.0	181.0	137.0

NOTE: n.a. = not available.

a. Consolidated balance sheet of the state banks before refection.

b. Consolidated balance sheet of the state banks after refection.

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

d. Reimbursements during the first nine months estimated at three-quarters of the total reimbursement for the year.

SOURCE: BCRG and liquidation unit.

TABLE 4.8

Profit and Loss Statement of Guinea's Commercial Banks, Financial Year 1987 (million of Guinean francs)

	BIG	BIAG	BICIGUI	SGBG	Total
Interest received	334	975	2,510	1,362	5,181
From banks	n.a.	505	414	134	1,053
From customers	334	470	2,096	1,228	4,128
Commissions received	383	979	1,669	1,303	4,334
On contingent liabilities	n.a.	61	257	557	n.a.
On foreign exchange operations	n.a.	n.a.	689	470	n.a.
On other operations	n.a.	n.a.	723	276	n.a.
Total operating income	717	1,954	4,179	2,665	9,515
Less					
Interest paid	210	35	342	72	659
To BCRG	n.a.	0	179	18	n.a.
To banks	n.a.	3	28	4	n.a.
To customers	n.a.	32	135	50	n.a.
Overheads	355	1,263	2,101	1,288	5,007
Personnel expenses	160	393	982	618	2,153
Other	195	870	1,119	670	2,854
Equals					
Net operating income	152	656	1,736	1,305	3,849
Less					
Depreciation	8	213	329	105	655
Provisions	130	234	1,886	564	2,874
Equals					
Net profit	14	209	−479	636	380

NOTE: n.a. = not available.

Source: Commercial banks.

TABLE 4.9

Some Ratios Pertaining to the Guinean Banking System, Financial Year 1987, by Bank

	BIG	BIAG	BICIGUI	SGBG	Total
In billions of GNF					
Average total assets	7.4	13.0	21.7	15.5	57.6
Average banking assets	7.3	12.6	17.8	14.7	52.4
Average deposits	2.1	10.4	13.6	8.1	34.2
Average credits	3.8	2.7	7.9	6.7	21.1
Operating income as percentage of:					
Average total assets	9.7	15.0	19.3	17.2	16.5
Average banking assets	9.8	15.5	23.5	18.1	18.1
Net operating income as percentage of:					
Average total assets	2.1	5.0	8.0	8.4	6.7
Capital funds	10.1	72.9	43.4	81.6	48.1
Net profits as percentage of:					
Average total assets	0.2	1.1	−2.2	4.1	0.6
Capital funds	0.9	16.6	−12.0	39.8	4.0
Interest received from customers as percentage of:					
Average credits	8.7	17.9	26.5	18.3	19.4
Commissions as percentage of:					
Average total assets	5.2	7.5	7.7	8.4	7.5
Operating income	53.4	50.1	39.9	48.9	45.3
Overheads	107.9	77.5	79.4	101.1	86.0
Interest paid to customers as percentage of:					
Average deposits	n.a.	0.3	1.0	0.6	n.a.
Overheads as percentage of:					
Total average assets	4.8	9.7	9.7	8.3	8.6
Personnel expenses as percentage of:					
Overheads	45.0	31.1	46.7	48.0	43.0

NOTE: n.a. = not available.

SOURCE: Commercial banks.

Nancy Benjamin

Comment

Roland Tenconi has given us a very complete accounting of the history of the Guinean banking system, the causes of the collapse, the process of liquidation of the collapsed banks, and the setup of the new banking system. He researched this under what must have been very difficult data circumstances.

We have a study of a specific case in front of us now. It would be useful to apply some of the conceptual points that were identified previously in this volume, in particular some of those from Professor Paulson's paper, to this specific case. Most of my comments on the paper will be in the form of questions in two principal areas: First, what else would we like to know about the Guinean case besides the anatomy of the banking system? Second, what can we learn especially from the unique characteristics of the Guinean case?

The first issue is the coordination of macroeconomic and financial reform. It has been mentioned several times that real economic developments are important for the banking system. To this end, I would like to know more about several real economic developments over the period that this financial collapse and restructuring took place.

First, since the banks are intermediating between real sources of savings and real investments, we need to know more about the fluctuations of these real magnitudes over the period, also, gross domestic product growth over time, GDP per capita, the kind of individuals who are doing

the saving, real savings rates, the structure of real investments, and the progress of the main export commodity prices, minerals and agriculture, just to give us an idea of the progress of the trade balance and foreign debt. What kind of macroeconomic pressures was the banking system under over the period discussed in the paper?

Second, since the government is such a major player both in the economy and in the financial sector, a major player in investment and financing and in the liquidation of the banks, I would like to know more about the impact of government credit creation. Thus it would be useful to have a brief history of the government deficit over this period and the size and importance of government investment.

The paper mentions government investment projects in agricultural collectivization and mechanization programs. Were there other major investment programs aside from these? Were there other activities of the public firms aside from the mining public firms that were mentioned?

The banking system becomes a place where overall macroeconomic pressures get pushed. We want to know how much of the Guinean banking system's problems were due to institutional weaknesses rather than outside shocks.

In the area of monetary policy, the paper tells us that money creation responsibilities were switched between agencies and that at one point monetary policy reform was undertaken. But we do not know what the monetary policy was and how it was changed during the reform.

I would like to know more about inflation rates over this period. I got the impression from the paper that monetary policy was somewhat in the hands of the people. The creation of fake certified checks, which could be deposited in a new bank account for immediate credit, in a sense placed money creation and credit creation in the hands of the people. This is a case where the population at large was in fact extracting seigniorage from the monetary authorities since they were making their own money.

Regarding fraud and corruption within the banks, there is mention of the supervision of the central bank, including on-site inspections. It does not seem to have had much effect. One problem identified in the paper was the incentives of those who were undertaking the on-site inspections. Those doing the inspections may have had the same incentives as those who were undertaking shady dealings or creative accounting, the same incentives to hide accounts that did not balance. So we might consider the institutional structure of supervision and inspection.

Finally, in this area of macroeconomic and financial reform, I would like to know more about how the informal financial system functions. Even if we do not have formal data on the size, we can ask for anecdotal information from those who participate in it and can tell us how it functions. What share of total loanable funds might it be handling? What

type of asset appears to be traded in the informal sector? Is there in fact a quasi equity market taking place in the informal sector?

The second area that I would like to raise is the concern of development objectives. The orientation and economic attitude of the government of Guinea are well described in the paper. So the question here is, What especially can we learn from the experiences of banking in a socialist country? This is a committed socialist government since the independence of the country in 1958. In the less centrally planned developing countries, we ask of bankers if the staff know enough about proper project evaluation. In a case like Guinea the issue of project evaluation was in the hands of the central planning authority, which decided on investment projects and dictated to banks the pattern of lending before the banking collapsed. What do we know about the quality of this economic planning and how that might have contributed to the quality of the loan portfolio? Was it the central planning system that helped create lax budget constraints for public firms, or was it the financial system?

In this respect, it is useful to consider the experience of other socialist countries that have undertaken various liberalization programs. They have found it necessary to liberalize banking along with production. Usually production was liberalized first, and that led to the need for more decentralization in banking. As private individuals began making production and investment decisions, there needed to be more liberty on the part of banks to lend to more decentralized firms.

I am thinking particularly of Hungary and, until recently, China. In Guinea it appears that production, international trade, and banking were liberalized at about the same time and that the participation of private firms in the formal banking system never became very important. So it is not the case of decentralized firms going to banks and seeking a less rigid structure of credit.

In this sense, is Guinea unlike other socialist countries that have undertaken liberalizing reform? The case of Tanzania would be interesting, perhaps more like Guinea than the others I mentioned.

The final issue I would like to raise is again one that Professor Paulson raised, that of credibility and the building of social institutions. This relates most closely to the future of banking in Guinea. Under the old system that led to a banking collapse, the attitude of financial market participants toward the banks seemed to be one of exploitation. Banks were something that could be used to extract funds that could not be gotten in other ways.

Since the generation of new banks, is this still the case? The new banks that moved in after the collapse are mostly foreign owned and largely foreign directed. They are profitable at this point, but their loan portfolios are weak. There are still weaknesses in the system. Have attitudes changed? How might they be changed?

In contrast, is the informal credit market a system characterized by a great deal of personal trust and mutual respect? Does the smaller and informal system of credit overcome this problem of lack of trust and respect?

Finally, I would like to ask, Are there good, viable, profitable investment projects in Guinea waiting to be financed by the right financial system? If not, why not?

Discussion

Alain Soulard: In Roland Tenconi's absence from these proceedings, I have been asked to assume the burden of response to questions about his paper and also to further our understanding of the circumstances that it describes.

It is questionable whether the Guinean banking system was in distress to start with. As is mentioned in Roland Tenconi's paper, the government sector, including public enterprises in the real economy and in the banking sector, was only one of three tiers of economic activities. Another tier was the mining enclave, dealing in foreign exchange and based on the bauxite and aluminum sectors. The third tier was the private sector, including an informal as well as a formal component, both real and financial. On the financial side the informal sector was dealing primarily in foreign currency.

The decision to restructure the banking system was largely the result of the change of government that took place in 1984–85 but was not dictated by any kind of financial economic urgency. In fact, the reason why the financial system was not in distress is essentially that there was no financial system in Guinea anyway. There was certainly no banking sector. There was a financial system only to the extent that currency was being issued and was being used within the country. Currency issue was, however, part of the problem.

The banking system—as outlined in the paper—was not really operating as a banking system because nobody in his right mind wanted to have any deposits in its banks, neither public sector enterprises nor private

individuals. Certainly private individuals had no interest in keeping deposits. The various instances of reforms or exchange of currency had been used before 1985 essentially as gimmicks to try to increase resource mobilization in artificial ways. It is symptomatic that all salaries above a certain level had to be deposited in the banks and withdrawals were limited to a certain amount of money, which clearly indicated that nobody really wanted to have any deposits.

The fairly large volume of deposits that appeared in the books was essentially due to fraud and corruption in various forms. Enterprises and individuals would have a friendly bank clerk certify a check, deposit it in another bank, and withdraw against that deposit. Interbank claims were growing rapidly, and deposits were also growing, but all this was essentially an artificial growth of the financial system.

So I do not think that there are very interesting lessons to be drawn from the reasons behind the restructuring of the Guinean banking system, except perhaps that it is better to have a banking system without corruption than one where corruption is pervasive.

Having said that, an interesting aspect of the restructuring of the banking system in Guinea was that, unlike the situation in other countries, no attempt has been made at rehabilitating the existing financial institutions. Instead, all six of the government's specialized commercial banks were closed down. Even the central bank was reorganized, and a new currency was issued.

The paper discusses the restructuring of the banking system, but it may be interesting to put the question more widely in terms of restructuring of the financial system, including the central bank and issuance of currency. There were, I believe, four different exchanges of currency between the time of independence and 1986, all of them with various little twists, such as deciding that some large-denomination bank notes would not be exchanged for new currency. All of them have been subject to various degrees of corruption in the sense that the exchange of new notes ended up increasing the volume of currency in circulation.

But there are interesting lessons now to be drawn from the restructuring of the system. My information is about a year old at this stage; so it may be a bit obsolete. But since we have the governor of the central bank in this audience, he will be able to help us with more recent developments.

In mid-1988 it could be said that the reform of the financial system had been successful. The new Guinean franc had gained reasonable acceptance. Currency in circulation was approaching 5 percent of gross domestic product, which is only slightly less than the 6 to 7 percent average of other African countries. Perhaps it is necessary to remember that foreign currency also circulates in Guinea. This might explain why the ratio of domestic currency to GDP is slightly less. Obviously, we do not have

information on the amount of foreign currency in circulation, but if we added it, then we would probably get closer to the usual ratio.

Total bank deposits in the new banks established after 1985 reached another 5 percent of GDP. But this constitutes dubious success for two reasons. First, this is substantially below total bank deposits in other African countries in the area. Second, the 5 percent of GDP figure for deposits is overstated relative to the International Monetary Fund definition, which would only consider private sector deposits. Private sector deposits were only about half of total deposits, or somewhere between 2.5 and 3 percent of GDP.

Furthermore, 40 percent of the 5 percent of GDP in total bank deposits were foreign currency deposits. The authorities had chosen to authorize foreign currency deposits as a means of capturing some of the transactions of the parallel economy, including foreign currency holdings, in an effort to increase confidence both in the domestic currency and in the new banking system.

In terms of the lessons and maybe some remaining questions regarding the impact of this restructuring, certainly the parallel existence of foreign currency and domestic currency deposits is one of the issues that is worth considering. Even though it is reasonable to discourage government from forbidding foreign currency deposits for fear of driving those transactions back into the parallel economy, at the same time the parallel existence of foreign and domestic currency deposits poses a number of constraints on the remuneration of both types of deposits.

In fact, foreign currency deposits were not supposed to be remunerated. At one stage, in fact, remuneration was actually forbidden, but given the rapid devaluation of the Guinean currency, there was an automatic remuneration of these deposits even when they were current account deposits. This remuneration did not accrue on Guinean deposits and therefore constrained the demand for current account deposits in Guinean francs. In mid-1988 that problem had not been satisfactorily resolved.

With respect to the remuneration of time deposits, the problem was that inflation had remained high and it was not obvious that the new banks were encouraging remunerated time deposits. In fact, most of the deposits in the banks were current account deposits. These included foreign currency deposits, but the burden of the remuneration of those deposits did not really fall on the commercial banks, for technical reasons that are a little too complicated to explain here.

The end result was that the average remuneration of the Guinean franc deposits in the banking system was rather low. It was less than 1 percent in 1987, at a time when inflation was somewhere between 25 and 39 percent per annum. Given that real lending rates were also negative, with nominal rates in the range of 25 percent or so, banks had an average return on their

loan portfolio of 20 percent, compared with an average cost of resources of less than 1 percent, and therefore had a spread of approximately 20 percent. So real loan rates, while negative, were not really a problem for the profitability of the commercial banks.

There are two other interesting issues besides the question of the comparative remuneration of Guinean franc and foreign currency deposits. One is the role of the branch network in both resource mobilization and the distribution of credit. This has been emphasized in many African countries. The Guinean authorities have been encouraging and, in fact, pressing at least one of the three commercial banks to open a relatively large number of bank branches upcountry.

Obviously, it is believed that there are both large amounts of resources to be mobilized and genuine credit needs in the rural areas. I personally believe that both reasons are wrong and that the establishment of a branch network, in the circumstances of Guinea at least, is costly and ineffective.

It is ineffective because even if it is successful in mobilizing large amounts of deposits from rural areas, this would probably constitute little more than a transfer of demand from currency in circulation to bank deposits. In other words, aggregate money holding would not increase very much given the relatively low remuneration of deposits. Most probable, instead, would be a transfer from currency issued by the central bank at a fairly low cost to bank deposits mobilized at a fairly high cost.

The usual argument for why there is not much credit in rural areas is that there is not much of a banking network, but this is a story we have heard before. In fact, it is questionable whether there are very large credit needs in rural areas in Guinea. Given that agriculture is based on extensive cultivation techniques, without much use of nonlabor inputs and without much use of equipment, it is questionable what credit could be used for other than for the commercialization of the crops. This is something that can be done and is being done by the commercial banks by giving credit to traders.

So I would like to suggest that it is not advisable to press the commercial banks in Guinea and comparable countries to open a network of branches. Such a network certainly adds to the cost of operations and gives them an excuse for high costs. The cost of bank operations will also be very high if they are essentially run by expatriates, who are quite expensive in relation to the volume of resources that may be mobilized.

I have no real solution to the problem except to suggest that the training of local staff should aim at reducing over time the relative importance of expatriate staff and also that a policy aimed at resource mobilization would help spread the overheads over a larger volume of resources and therefore reduce intermediation costs.

In many countries the World Bank and the IMF have been recommending that competition should be increased by allowing the entry of foreign

banks. I wonder, in looking at such diverse countries as Guinea and Turkey, whether the contribution of foreign banks to competition and to the efficiency of the banking system is as great as expected when those recommendations were made.

In the case of Guinea, maybe. There was in fact a need for some banking expertise to be brought in from outside and a need to ensure that the level of corruption that existed (and that to some extent still exists) in the banking system of Guinea was somewhat under control.

The new level of resources mobilized by the banking system has been mobilized at a fairly high cost. It was not obvious in mid-1988, when I left the Guinean banking system, that these high costs would later be spread over a larger volume of resources or that there would be a considerable savings in intermediation costs. These are some of the considerations that might warrant continuing analysis.

Kerfalla Yansane: Speaking as governor of the Central Bank of Guinea, I want to say that I think both the paper and the discussion thus far reflect reality to a large extent, but a more complete picture of reality is enabled by initially placing the overall restructuring program within the context then prevailing. In 1985 there were two major shocks to the Guinean economy. First was a shift, as has been outlined, from a highly centralized economy to a more open and liberal economic environment. The second shock was on December 22, 1985, when the head of state decided that all existing banks would be closed the next day. When bank employees showed up, banks were closed.

It is possible to understand the difficulties faced at the time and later on in the restructuring process as principally resulting from the economic shock of closing the banking system and also the political issues raised with the laying off of approximately 4,000 people who were employed in the banking system at the time. I want to take issue with the statement that there was no good reason to close the banks; to be able to conduct a process of structural adjustment in the economy broadly, it was necessary to have a banking system that would not be illiquid, insolvent, and staffed by corrupt employees. The steps taken by the government can be categorized as advancing truth in all matters—truth in prices, truth in exchange rates, and true financial discipline in terms of both the public sector employees and the budget constraints.

It is necessary to understand that the issuance of currency in the previous regime was not under the authority of the central bank but was under the discretionary authority of the president, who would send the necessary papers to the central bank as an order to pay. Obviously, such a system could not have been continued in the context of structural adjustment.

To complete the overall context of the financial reform, one has to consider that not only were bank employees laid off but at the same time a

number of public sector enterprises were closed and their employees laid off. In the government bureaucracy, a number of government employees were laid off; total public sector employment was cut in half, from 90,000 to 45,000 employees.

So the government felt that there was a need for a strong private sector to develop and offer employment opportunities to these people and that the private sector needed an equally strong banking system to provide financial services. Given the state of disarray of the local banks, it was felt necessary at the time to invite foreign banks to come and restructure the banking system.

A few French banks showed some interest, but they could only be persuaded to establish themselves in exchange for what the government viewed as exorbitant advantages. But this was seen as the quid pro quo for a real involvement of these banks in the economic development of the country.

It is also necessary to keep in mind that closing the banks is not enough in and of itself, that there was a need actually to undertake a liquidation of these banks. This was all the more difficult since there were no proper accounts, no reliable documents available. There was also a need to show some resistance on the part of the central bank to increasing the reimbursement of deposits. In this respect, it is felt that the paper under discussion is a bit unfair in suggesting that insufficient control has been kept on this reimbursement of past deposits.

Alan Gelb: It might be helpful to explain the origins of the study at the World Bank that is represented in this chapter by Roland Tenconi. We have been putting together a set of case studies of how countries have coped with problems of widespread insolvency in financial systems. There are only a few cases in Africa—and Guinea is one of them—where something has been done. It is indeed an extreme case, in terms both of the nature and the severity of the problem and also of the courage with which reforms were undertaken. Reform was indeed very radical—closing down an existing system and bringing in a foreign banking system. Although it is very unusual, there are some interesting lessons for other countries that face similar problems and to some degree confront similar options.

The first basic question this study raised to me was, Under what conditions does it make sense to have a formal financial system? We tend to think of formal financial systems as having a few very broad basic functions: they mobilize savings; they intermediate savings so that they can be well used; they also generate seigniorage, that is, they provide a certain flow of revenue to governments either through issue of currency or (in the case of banking systems) through the ability to levy certain implicit and explicit taxes on the banks.

In Guinea we find that the system was turned upside down. It was not being used to mobilize resources in any meaningful way. It certainly was

not being used to allocate resources to productive uses. Fraud encouraged uses that perhaps were undesirable. As Nancy Benjamin pointed out, it offered a form of reverse seigniorage; it probably cost the government more to fix up the system or to pay out depositors than it ever received from the system in taxes. So there is a question under what conditions, in terms of political and macroeconomic stability, legal framework, accountability, and so on it makes sense to try to maintain one's own formal financial system.

Under what conditions would one wish to liberalize a formal financial system to encourage it to absorb a larger proportion of resources? Would one really want a financial system with the characteristics of the Guinean system to absorb more savings from rural areas? One suspects the answer may well be no. So what are the prerequisites for an efficient form of financial system?

The next question is the role of foreign banks, an important one in considering the options facing governments, particularly in African countries, where the range of domestic choices may be quite small. In the United States there is a well-developed mechanism for dealing with failing institutions, but it requires other institutions capable of taking over those institutions. In many countries those do not exist; then what is the role of foreign institutions? Should it be much greater than at present? Should we be thinking of management contracts rather than inviting in foreign banks?

Next, the move from centralized to decentralized systems is important for a number of African countries. It is instructive to evaluate the experience of countries outside Africa that have been trying to move from centralized to decentralized economic systems, the implications for their financial systems, and the difficulties that arise in that process.

C. S. Kimei: Being with the Bank of Tanzania, I would like to share my views on reform with reference to the Tanzanian experience. The Guinean case seems to be a little extreme, but the premise under which reforms are being undertaken seems much the same as for Tanzania. In both cases there is a movement toward more liberal policies. Financial reforms are being undertaken to support measures aimed at reviving the real economy.

The need for consistency between the real economy and the financial system is compelling the authorities to reform the financial sector. I was fortunate enough to participate in some of the discussions of Tanzania's Banking Commission. Among the findings of the commission has been the realization that the premise on which economic policy has been conducted was wrong. The prices for goods, capital, and labor were regulated and therefore provided wrong signals. They diverged widely from those that would have emanated from a free interplay of market forces. One result of the new policy spawned by this reassessment has been that bank workers have experienced a dramatic decline in real wages. Those who were paid

about $700 per month in 1960 are now being paid a little over $50 a month. This indicates that the monetary or inflation policy that passively accommodated fiscal policy was wrong and was not conducive to increased productivity. High inflation led to deterioration in real wages. As a result workers in general, and bankers in particular, compensated by increasingly engaging in corrupt practices. Banking ethics drastically deteriorated, and public use of the banking system as a safe depository and a payment mechanism sharply declined. In consequence the financial-asset-to-GDP ratio declined in tandem with a rising currency ratio.

Most of the people who were interviewed by the Banking Commission were unhappy with the banking system because banking ethics had deteriorated. A frequently heard complaint was of the willingness of bank workers, in exchange for small payments, readily to disclose information about transactions in deposit accounts to anticorruption squads, as well as to friends who were trying to get the information for their own various purposes.

Workers have had to resort to something other than their official employment to make ends meet. They either steal or work part time and devote some time to informal sector activities. The implication of the latter has been a deterioration of productivity in the banking system. This case may suggest that, even if the financial sector is reformed, the reform may not be effective if the fiscal policy framework is not reviewed with respect to such things as wage controls and other regulations on the markets. The legal framework has to be reviewed as well to allow competitive bank chartering and less government interference in affairs of economic units—whether public or private. In short, the whole macroeconomic policy framework needs to be reformed.

If banks cease to function as a payment mechanism, transaction costs increase, and economic efficiency declines. The banking system is thought to be an efficient and safe payment mechanism, because if a client wants to make payments by a telegraphic transfer (TT), it is expected in a matter of seconds. In Tanzania nowadays a TT takes up to four weeks, and it thus becomes much faster and more convenient to carry one's own money for an intended payment. This, of course, hampers resource mobilization. In addition, bank drafts have ceased to be readily acceptable. We have only one bank, National Bank of Commerce (NBC) with about 300 branches spread over the country. But one branch of the bank hesitates to accept a bank draft issued by another branch.

How could the nonacceptability of bank drafts among branches of the same bank come about? Let me illustrate. A manager in one branch may issue a draft to a client who wants to buy some goods but has no working capital. The goods are then paid for by use of a bankers' draft, which is drawn without an equivalent deposit of money into the issuing branch.

Although the money is deposited to the branch after the client resells the goods, the whole arrangement amounts to a grant of interest-free credit by the bank. Of course, the manager is paid informally, off the books, by the client. As a result of this misuse, the NBC management had to stop the automatic acceptability of bankers' drafts and establish measures for verifying their authenticity.

The whole thing hinges on corruption, and the rise in corruption corresponds with deterioration of real earnings of workers and of banking ethics. In more general terms, the scenario has resulted from wrong price policies, with respect to wages, interest rates, and goods.

In a setting like Tanzania it becomes difficult even to establish project viability in the traditional sense, because prices are not giving the right signals. One cannot appraise a project and say that the project is bankable when the prices being used have no relation to the market. On the same premise it is arguable that parallel markets in Tanzania, and probably in Guinea as well, have been driven by the fact that economic policies have been wrong with regard to the formal markets. The prices in the parallel markets have been extremely high because official prices were fixed at a level far below market clearing, thereby creating excess demand and shortages. These formed the basis for the parallel market and for increased hoarding of currency for parallel market practices. The growth of the parallel money market has strengthened the informal financial sector in Tanzania. No one has thoroughly studied the extent of this market in Tanzania, but I think it is huge and that its size can be gauged by the rising currency ratio and the declining intermediation ratio.

To determine the root causes of the problems, one should look at the issue from a historical perspective. The Tanzanian financial system was not always so ineffective. In 1961 Tanzania became independent, and in 1966 its central bank was established. The financial system was operating reasonably well and conformed to the most successful practices that would normally be found in other countries. The legal framework within which the central bank operated was conducive to the conduct of noninflationary monetary policy because the government has bank borrowing limits specified in the statute. With amendments of the Central Bank Act in 1978, however, the limits were relaxed, and the government found it easy to overstretch its resources by forming public enterprises that could never recover their costs. From 1979 the whole thing started collapsing. As for the banking system, after the 1967 nationalization efficiency in resource mobilization took a dramatic downturn in the second half of the 1970s. By 1989 the financial asset ratio had declined to about 36 percent, and it had already risen to over 60 percent in the mid-1960s.

Thus history reveals that things in banking and elsewhere got worse. Inflation became chronic; yet the government insisted on policies initiated

in 1967 without making adjustments to allow for changes in wages, prices, and so forth, to reflect real economic conditions.

Further, in countries like Tanzania the legal framework is an important tool for guaranteeing adherence to policy commitments. I think the legal framework should be studied and measures suggested on how that framework can be made to be instrumental to the proper conduct of macroeconomic policy. In particular, the legal framework should address the issue of autonomy between the treasury and the central bank. The significance of this may be judged from French banking history, as contrasted with developments in other banking systems. It would appear that the degree of autonomy between the central bank and the treasury is very important for proper implementation of policy.

Another issue is what has been referred to as "designing a competitive banking system within a socialist framework." What is a competitive banking system under a socialist framework? That is completely ambiguous. One cannot rule out the fact that the government probably will not accept a report that denounces public ownership in financial institutions and echoes a return to precolonial banking structures. So since the commission is already constrained to thinking within a socialist framework, it has the challenging task, at the outset, of defining what that framework means.

Reinhold Van Til: I would like to be a bit more provocative on the issue of the relationship between the financial sector and the real sector. Everybody at this conference seems to be saying that if things go bad in the real sector, then of course they go bad in the financial sector. I am not so certain: is that really the source of the problems? Of course, if we have large devaluations then we see bad loans appearing, and basically the solvency and the liquidity of the banking system are at stake.

I also have some questions about the informal sector. Do bad loans commonly occur in the informal sector? Do negative real interest rates occur in the informal sector? What kind of lessons can be learned, so to speak, from the institutional arrangements in the informal sector that may be helpful in framing the formal financial sector?

Joshua Greene: In reading the paper, I was struck at the extent of corruption in the Guinean system. An important question for us to ask is, How extreme a case is this? Are we dealing with many, many banking systems that have aspects of this in them? If so, what does this mean for the financial sectors and financial sector reform in Africa? I am hoping that some of the participants from African countries will comment on this issue. I would like to believe that it was a very extreme case and therefore unrepresentative.

In the same way, as a public finance analyst I was struck by the tremendous tax allowances the foreign banks were given as inducements to enter Guinea. Were these really necessary? While I realize from the

paper that efforts are now under way to try to scale back some of these allowances, it is a very disturbing thought that inducements of this scale might be needed to bring in direct investment in the sector.

Julius Coles: I was taken aback by Mr. Soulard's denial of the need for rural banking. At least it goes against the grain of what some development people seem to think. Even though banking systems located in urban areas can provide some financing for farmers and other rural producers, he seems to suggest that it is too costly to have a rural banking system—that there is not enough profit out there to induce the banking system to go into a rural area. Does one need rural credit to finance inputs and things other than just the marketing of produce? Or does one really rely on the informal banking sector to handle those types of problems, accepting the need for greater attention to urban banking? There is a whole series of questions here.

Mohamadou Diop: I would like to address two issues. I want to talk about the motivation of foreign banks, because I think there are some considerations that should be brought to the attention of people involved in this seminar.

Most of the foreign banks that are likely to intervene in Africa are European banks. There are very few American banks involved. As you know, since Citibank took the initiative of increasing, in a very significant way, its loan loss reserves, there have been decisions taken among European central banks to impose minimum levels of provision for country risk, complemented by the so-called recuperation, which requires banks to put aside a certain amount of reserve, whatever the quality of the risk in certain countries.

This puts tremendous constraints on these European banks, particularly when we take into account that they are already highly exposed to country risk, whether directly or indirectly, through local branch banks. For each 100 francs in equity risk or loan risk that any European bank today is to put in Africa, they have to put aside 40 as a loss provision. And when we take into account the recuperation, they may have to put aside another 20 of equity.

The result is that nowadays the European banking community is not interested in investing in Africa. And even if it were, it is constrained by these considerations. When, for various political or sometimes even for balance sheet reasons, they do intervene, the objectives in the short term are maximization of profit and minimization of capital outlays. Therefore, they will want to put in, say, 20 percent to have the management and to get 80 percent equity participation from local investors.

The need to maximize profit leads them to look for various fiscal exonerations that may be or may not be economically defensible. At the same time they have to minimize resource mobilization; we all know the result today for the banks that have made the mistake of investing heavily in network branching.

Therefore, there are two important issues. One is the extent to which these foreign banks should bear the losses incurred by their affiliates and branches in Africa. The second is, in the cases where they are not involved, to what extent they can be induced to come in and participate both institutionally and financially in the restructuring of the banking system.

I have seen much corruption in Africa. Wherever there is institutional corruption, there will also be personal corruption. I would venture to say that today one of the least corrupt areas in Africa, whether it be in the public or private enterprises, is the banking system, simply by virtue of its nature. Corruption is more difficult in an industry that relies on written records and double-entry bookkeeping.

Patrick Honohan: I want to draw our attention to two facts coming from the Guinea case. One is the foreign banks: what do they do? They are scarcely banks in the sense of mobilizing deposits and lending. They are little more than money transmission agencies. We can see that in the importance of the fee income ("commissions," in the Tenconi paper), which is only more dramatic in Guinea than in other countries. That is what the foreign banks, colonial banks, do in Africa. They provide a very good money transmission service. Do not expect them to do very much else.

The other fact from Guinea: I think that confidence in the banking system has overcome the suspension of operations and the long delays in getting repaid from deposits. The new banks did obtain a certain degree of public confidence. The deposits in the new banks are much larger than the deposits in the old banks were when they failed. I know they are much smaller than in most other countries still, but it was possible to reestablish some degree of confidence.

Donald Mathieson: In considering this particular case, it was said that the solution to the restructuring problem was unusual. I would suggest that it is fairly common, in fact, in the sense that the typical way in which to get restructuring costs out of the system is to inflate them out. Historical experience suggests that governments fix interest rates and then inflate these costs away.

But the African experience with the foreign banks raises a much more fundamental issue, which is the question, if one leaves aside the politics, of whether modern nation-states provide the appropriate bases from which to organize financial market structures. The answer to that question, at least in the industrial countries, is no. The "1992" program in Europe suggests that its financial markets, which are much more sophisticated than Africa's, have exceeded nation-state boundaries. But we persist in talking about financial reform in the context of nation-state boundaries.

In economic terms the question is what financial system is viable. This raises the issues of what level of competition one gets in the system and what financial services one imports or produces domestically. All of those, I

think, are questions to which we do not have very many good answers at this stage.

Alain Soulard: Just a quick response to Julius Coles's objection a moment ago to my observations on rural credit. It is a complex subject, with several dimensions to it. I was really speaking from the point of view of countries where agriculture is very extensive, meaning, as my agronomy colleagues tell me, that neither a great deal of input nor a lot of equipment is used. Whether they are not used because there is no credit, or, conversely, they do not need the credit because they do not need the input and the equipment is open to debate. But from what I understand, in those cases where credit and equipment have been made available on a voluntary basis under various government programs, they have often failed to yield the kinds of results that were expected.

So I assume that, to a large extent, the reason why agriculture has remained "primitive" is simply because that was its comparative advantage at that stage of development in the agricultural sector. Where more intensive techniques have been used, plantations and so on, usually these are programs that have been sponsored by a variety of international organizations, including the World Bank, and credit has been made available to finance inputs, equipment, and so on.

The credit requirements that remain unfulfilled, I still believe, are fairly limited in most cases. I do think that the banking system is not very well equipped to finance whatever remaining credit needs there may be at the level of individual farmers. To some extent, however, that function can be left to those people who do happen to have, if not daily contacts, at least regular contacts with the farmers and who know their credit-worthiness, namely the people who distribute the inputs, the fertilizer, or who buy production (who may or may not be the same people).

Credit demand, again, is only one aspect of the question. Recently it seems that more emphasis has been placed on the resource mobilization side of rural finance. People have been arguing that there are a variety of institutional arrangements that do contribute to resource mobilization.

Relating this to all potential savers, one has to remember that in many countries, and certainly in Africa, the government is rarely a saver. Private enterprises are either nonexistent or do not save very much. So the household sector is the primary saver, but usually not in urban areas. It follows that household savings must be coming principally from the rural sector. Which is the best way of mobilizing those savings? Some people have been referring to the importance of the informal sector and the impact it has on currency circulation. This contribution is good where it is required, but is it good that the requirement exists? Consider that an efficiently managed central bank, I understand, has a cost of managing currency circulation of approximately 0.5 percent of currency in circula-

tion on an annual basis. This is not the case in Guinea for various reasons. But the cost of currency should be much lower than the 7 or 8 percent cost of administration of the banking system assets that is mentioned in the case of Guinea. Therefore, I would suggest that perhaps some countries do not really need to have a lot of banking in rural areas, that there is a more efficient way of mobilizing resources, which is called currency holding. After all, currency is part of financial savings. So there must be some virtues in having some reasonable level of demand for currency, even though that may be, in the eyes of some people, less desirable than the expansion of the banking sector.

85

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Barber B. Conable

Financial Restructuring in Ghana

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

The country is well endowed with natural and human resources. Agriculture accounts for 41 percent of GDP and provides income for about

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This chapter is excerpted from the *International Development Association Report and Recommendation of the President of the International Development Association to the Executive Directors on a Proposed Development Credit to the Republic of Ghana for a Financial Sector Adjustment Project*, signed on May 9, 1988, and submitted by representatives of the World Bank to the conference from which this volume is derived, pursuant to the purposes and publication of the conference proceedings. The report and recommendation address a proposed development credit for the equivalent of SDR 72.1 million (U.S.$100 million equivalent) to the Republic of Ghana on standard IDA terms to help finance a Financial Sector Adjustment Project.

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

The Economic Recovery Program

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

The ERP's major objectives were (1) to shift relative prices in favor of production, particularly for exports and efficient import substitution; (2) to restore fiscal and monetary discipline; (3) to initiate the restoration of the country's social and economic infrastructure; and (4) to encourage private investment. The centerpiece of the reform was a move to introduce a more realistic exchange rate. The cedi was devalued from 2.75 cedis to the U.S. dollar in April 1983 to 90 cedis to the U.S. dollar by January 1986. In September 1986 the government introduced a second-tier auction system, and in February 1987 the auction and official exchange rates were officially unified. Initially the auction was limited to producer goods, but its coverage has been expanded steadily, and by February 1988 all imported goods were eligible for funds from the auction. Administered prices, particularly for cocoa and petroleum, have been adjusted at regular intervals to reflect changes in the exchange rate, and widespread price and distribution controls have been abolished. Interest rates were adjusted upward steadily, and finally in September 1987 all interest rates except those for savings deposits were liberalized.

In the area of fiscal policy, the government's efforts have concentrated on eliminating subsidies, mobilizing resources through improved tax collection and selective increases in taxes, and providing more adequately for maintenance and capital salaries to offset partially the drastic erosion of real incomes in previous years. At the same time, the government reversed the previous severe compression of salary differentials between the lowest and highest paid members of the civil service.

The response of the economy was crippled initially by the drought in 1983 and insufficient aid flows. After 1984, however, performance improved on several counts. Growth averaged over 5 percent a year, the government's

fiscal position improved markedly, the rapid growth of the money supply was curbed, and the trade balance improved substantially. In addition, the government introduced significant improvements in policies on public expenditures. It initiated rehabilitation programs for infrastructure in the cocoa, timber, gold, and transport sectors. At the same time the government prepared a rolling three-year development program based on reviews of public expenditures conducted jointly with the International Development Association (IDA). At this stage the high level of inflation (39 percent in 1987) remains a major concern. The main reasons are (1) the significant devaluation of the currency in 1986, (2) the decline in food production, (3) the increase in domestic petroleum prices, and (4) a 50 percent rise in M2 in the latter half of 1986. There are signs that inflation is decelerating, however. The national consumer price index rose only 5.1 percent in the second semester of 1987.

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

Ghana's total external debt in 1987 was estimated at U.S.$2.6 billion, including U.S.$1.76 billion medium- and long-term foreign debt. According to International Monetary Fund (IMF) and World Bank estimates, the country's foreign debt is likely to increase over the years, reaching U.S.$3.24 billion in 1990 and U.S.$4.6 billion in 1995, with medium- and long-term debt reaching U.S.$2.49 and U.S.$3.74 billion, respectively. In

1987 the debt-service ratio excluding IMF and arrears was 26.3 percent (60.5 percent including IMF debt service and payment of arrears), down from 37.7 percent the previous year. This debt-service ratio, however, is expected to decline steadily in the future, reaching 30.1 percent (including IMF debt service and payments of arrears) by 1990.

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

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

The Financial Sector

Background. Work on Ghana's financial sector began some two years ago, as the structural adjustment process was under way, because the financial

system appeared to be potentially a serious constraint to growth in the real sectors. This culminated in a major review in April 1987 by a joint working group of Ghanaians and bank staff, which identified key problems and proposed a wide-ranging program of reforms (the Action Program), which the present operation intends to support.

The structure of the financial sector. The formal financial system is dominated by three primary commercial banks—the Ghana Commercial Bank (GCB), the Standard Chartered Bank of Ghana (Standard), and the Barclays Bank of Ghana (Barclays); seven secondary banks—the Social Security Bank (SSB), the Bank of Housing and Construction (BHC), the Agricultural Development Bank (ADB), the National Savings and Credit Bank (NSCB), the National Investment Bank (NIB), the Merchant Bank, and the Bank of Credit and Commerce; a small cooperative bank, Ghana Cooperative Bank (Co-op Bank); and over 100 rural banks. Of the total assets of the banking system of around 156 billion cedis (about 25 percent of GDP), some 57 percent are in the three primary banks, although the secondary and rural banks have been growing faster. All the primary and secondary banks accept deposits from the public, and, with the exception of the Bank of Credit and Commerce, all are either partly or wholly owned by the government. Table 5.1 details the aggregate assets and liabilities of the banking system.

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

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

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

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

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

Like the rest of the economy, the banking system in Ghana has suffered adversely from the generally low level of productive activity during the period of economic decline, although a few institutions are reportedly profitable and relatively efficient. Its current distressed situation can be characterized inter alia by (1) huge nonperforming loan portfolios, (2) inadequate provisions for portfolio losses, (3) inflated profits, (4) high operational costs, (5) potential or actual foreign exchange exposure, (6) insolvency, (7) capital inadequacy, and (8) inadequate accounting systems, management information, and internal controls. Comprehensive external diagnostic audits by international auditors have been undertaken for the nine main banks (GCB, SSB, Barclays, BHC, NIB, ADB, Standard, NSCB, and Co-op Bank) to obtain an in-depth and accurate assessment of the operating and financial condition of each of them and provide a basis for determining their restructuring prospects and requirements.

The Policy and Regulatory Framework

Deposit mobilization. The formal financial system has not proved an effective vehicle for mobilizing domestic resources. The M2-GDP ratio in Ghana is low by international standards and indicates the low level of financial intermediation in the economy (Tables 5.2 and 5.3). During the 1970s and early 1980s, liquidity expansion was fueled by large government deficits financed domestically by the central bank. Excessive money

creation at a time of stagnant growth and investment stoked inflation and turned government-determined deposit rates deeply negative in real terms. In addition, the lack of longer-term lending opportunities provided few incentives for banks to attract term savings. Instead those with surplus funds tended to invest in inflation-hedged assets such as real estate.

Since 1983 the Ghanaian authorities have pursued a flexible interest rate policy aimed at mobilizing domestic savings (Table 5.4), in line with their growth and stabilization objectives. Accordingly, minimum rates for savings and time deposits were adjusted upward repeatedly from 8.25–9 percent in 1983 to 22–23 percent in 1987. In addition, declining inflation during this period as a result of fiscal and monetary discipline on the part of the government helped turn real deposit rates positive for the first time in more than a decade. As the rate of inflation climbed in 1986 and 1987, however, real interest rates once again turned negative. In September 1987 the government liberalized all interest rates except for savings deposits, which have been pegged at a minimum of 21.5 percent. Full liberalization was achieved in February 1988.

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

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

The poor record of deposit mobilization by the banking system can also be attributed to the inferior quality of customer services of a number of banks and the limited range of financial instruments aimed at mobilizing savings. In addition, banks find it difficult to improve the efficiency of their operations and reduce intermediation costs because of antiquated systems and procedures and the shortage of trained and qualified staff. The Bank of Ghana regulates charges that banks can levy on their customers, thereby

curtailing competition between banks and reducing incentives to improve efficiency. The efficiency of banks is also affected by the lack of high-denomination currency notes. The Bank of Ghana recently issued a 500-cedi note and plans to introduce a 1000-cedi note shortly. But a case can be made for yet higher denominations that can shorten queues in banks and reduce the costs of counting large wads of notes. As far as the branch network of the banks is concerned, the banks are required to obtain the permission of the Bank of Ghana before altering their opening and closing hours. This practice reduces the ability of banks to respond effectively to the needs of their clientele and could therefore be eliminated.

Credit allocation. The Bank of Ghana has been controlling the growth and allocation of credit by the banking system through global and sectoral credit ceilings. To determine the total quarterly credit expansion by any individual bank, the Bank of Ghana first determines the overall rate of credit expansion consistent with projections of steady economic growth and inflation. Until February 1988 sectoral growth rates were established according to the development priorities of the government, and guidelines were then issued to individual banks on the basis of the application of those growth rates to the outstanding loans at the beginning of the period. The allocation for agricultural lending (20 percent of the total) served as a minimum, whereas for other sectors it was usually a maximum. All sectoral lending targets have now been removed, except for agricultural lending.

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

Partly as a result of interest rate controls, term transformation has been a problem for the Ghanaian banking system. Banks were unable to compensate for risk and maturity by varying their interest rates. In addition, the high proportion of banks' liabilities at the short end of the maturity structure (mainly demand deposits) has constrained their ability to lend long term. Furthermore, large holders of long-term funds, such as the SSNIT, were compelled to purchase low-yielding government stock to finance the government deficit. These constraints, along with the limited number of viable investment opportunities brought to the attention of the

banks, served to hinder the flow of financial resources for investment. The banks have tended to lend short term, mainly to their established customers, a high proportion of whom are in the trade and service sectors. In 1986 it is estimated that only about 15 percent of commercial bank loans outstanding (including those of development finance institutions) were of maturities over three years, and nearly 50 percent of all loans were to trade and services (Table 5.5).

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

In late 1987, however, a situation of excess liquidity once again emerged. The banking system appears unable to absorb the net repayments by the government, especially since it cannot rechannel these to the private sector on account of the credit ceilings. As a result, some banks have been turning depositors away, and private enterprises with surplus savings are finding means of lending to deficit enterprises directly rather than going through banking institutions. The crowding out of private sector financial savings was exacerbated by the substantial expansion of credit by the Bank of Ghana to the cocoa sector, which has added liquidity to the system, adversely affecting the operations of the newly opened discount house and sending interest rates at the Bank of Ghana's recently introduced treasury bill auction below the minimum savings rate and the rediscount rate.

The present situation of excess liquidity in the banking system is coincidental with a shortage of liquidity in parts of the manufacturing sector. The demand for credit in the manufacturing sector has risen sharply as a result of increased import costs, 100 percent deposit requirements for the foreign exchange auction, and improvements in the efficiency of tax collection. But the banking system has been unable to intermediate between the resource-rich cocoa and mining sectors and the resource-hungry manufacturing and food crops sectors. The distortions created by the credit ceilings are beginning to make it difficult for the central bank to manage liquidity. This points to the need to develop as rapidly as possible

indirect instruments for monetary management that are capable of absorl ing or injecting liquidity as and when required. But the issue also goc beyond one of just introducing new instruments. It means that the financi sector needs to develop a secondary market in government-backed secur ties and commercial paper and use it to manage its twin objectives (liquidity and profitability. The government is putting together a plan t address these issues, including the sale to commercial banks of cocoa bill a better monitoring of banks' cash reserves, and the timely issuance by tl Bank of Ghana of short-term paper.

Money market. The potential usefulness of a money market in Ghana ha been recognized for some time, and one discount house, Consolidate Discount House Ltd. (CDH), which is owned by banks and insuranc companies, has recently become operational. After opening for busine: on November 30, 1987, however, and an initial flurry of activity during tl first days, few transactions have subsequently been carried out by the CDI This disappointing performance can be traced to a combination of inad quate detailed agreement between the CDH and the Bank of Ghana on a operational framework, unrealistic expectations by banks as to the absorp tive capacity of the CDH, and imprecise definition of the scope of the CD by all parties.

The Ghanaian authorities are now in the process of taking the requisi steps to facilitate the development of a smoothly functioning mone market. These will include consideration and resolution of the followir defects and shortcomings: (1) prudential limits on the composition of CD assets; (2) the liquidity status of money-at-call with the CDH; (3) the CDH method of computing interest; (4) access by the CDH to a rediscou facility with the Bank of Ghana or to any assured supply of treasury bills; (5 the status of call money deposits by banks with the CDH; (6) the effect (the banking license issued to the CDH; (7) continued access of banks to tl Bank of Ghana for accommodation of their liquidity; (8) definition (bankers' acceptances eligible for rediscount at the Bank of Ghana; (9) tl Bank of Ghana's policies for the sale to nonbanks of bankers' acceptance (10) further to (4), the basis on which the CDH and the Bank of Ghana de in longer-dated government stock.

Capital market. Ever since the early 1960s, when a comprehensiv companies code was enacted, Ghana has been considering the introdu tion of a formal stock exchange. The clear benefits of such an institution, i Ghana as elsewhere, would be to enable corporate issuers to gain access t long-term funds provided by investors, both individual and institution and to provide liquidity in the secondary market for shares and bonds. Tl Accra Securities Market Ltd. (ASM) has been formed for some years but n activated. Ghana, however, already has public issues of companies. Son eighteen companies, owned primarily by foreign shareholders, we

converted into public companies during 1975 and 1976, under the operation of the Investment Policy Implementation Decree. The only other issues since 1976 have been one issue involving the capitalization of reserves and a failed rights issue, which was less than 25 percent subscribed.

It may be generally observed that these public companies, some of which are among the largest enterprises in the land, either have not needed to raise capital from the public during the past decade or have argued that the program of divestiture of state-owned enterprises could best be accomplished through a stock exchange. Indeed, if such an exchange existed, it would be a natural conduit for such transactions. It is unlikely to be satisfactory, however, for either the government or the future development of the capital market in Ghana for an exchange to be created based mainly on such a short-term flow of captive business. Furthermore, divestiture sales are not primary issues, since no funds are raised for the subject company, unless the sales are combined with a new issue of stock by the company.

One practical way to test the proposition that both supply and demand in primary markets will be available in quantity is to provide some incentives to private placement of equities and to monitor the resultant flow of investment. Incentives to corporate issues could range from elimination or reduction of the 2 percent stamp duty on capital increase to permanent or temporary reduction of the corporate tax rate for companies attracting new capital. Investors might be encouraged to make equity investments by exoneration from capital gains taxation, by equalization of the tax treatment of bank interest and dividends, or by the ability to make investments up to a stated maximum limit out of pretax income. It seems that dividends in Ghana were treated as tax free for some years in the 1970s.

In addition to the considerations above, there are a number of other concerns that need to be addressed. These include the following: (1) the review of auditing standards applicable to public companies should be accelerated, so that any recommendation for improvement may be implemented well in advance of any stock exchange activity; (2) the institutional and regulatory framework for any exchange must be devised and erected before any attempt is made to activate the ASM; (3) the possibility of forming a vehicle for provision of venture or development capital could be considered, which would hold the prospect of acting as a nursery for companies that could, on maturity, be sold to public investors through the exchange; and (4) the pricing policy and mechanism for new issues on the ASM should, ideally, be left in the hands of professional advisers to corporate issues. The Technical Subcommittee for the Establishment of a Stock Exchange reported in 1986 that a Capital Issues Commission, under the auspices of the Ghana Investments Centre (GIC), should fulfill this pricing function. Although such a proposal seeks to use the skills that are available within the GIC to provide an objective framework for price

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

Regulatory policies. Regulation is intended to provide monetary stability, protection of depositors, and an efficient and competitive financial system. In Ghana banking activities are governed by the Banking Act of 1970, the Banking Regulations of 1973, the Bank of Ghana Act of 1963, and amendments or decrees issued in due course since the enactment of the foregoing legislation. Several serious omissions in this body of legislation, together with weak bank supervision, have led to the concentration of risk in the portfolios of banks, inadequate capital and reserves, inflated profits, and unrecognized loan losses.

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

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

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

Other weaknesses or omissions exist in the current body of banking legislation. Development finance institutions engaged in commercial banking activities are not subject to these requirements regarding the transfer of

retained profits to the reserve fund. Monetary penalties cited within the legislation have not been revised upward to reflect the effects of inflation and therefore no longer serve to discourage illegal or imprudent acts. Prudential reports and audit reports submitted to the Bank of Ghana are inadequate as sources of information with which to conduct off-site or early warning analysis. And a mechanism such as a credit clearinghouse does not exist to provide for the sharing of credit information between banks.

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

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

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

An Agenda for Action

The development of an efficient and broadly based financial sector is crucial for the continued adjustment effort of the Ghanaian economy. The

government has prepared a Statement of Financial Policy, which details the policy framework for reforms to be undertaken (including an implementation schedule) that the proposed credit would support. The main objectives of this program are outlined below.

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

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

The increased flexibility in the government's policy toward interest rates has led to a discernible increase in the willingness of the public to hold deposits with the banking system. In addition, the Bank of Ghana will agree with the IDA on a timetable for decontrolling banking charges before February 1989.

Efficiency of credit allocation. The Bank of Ghana has already taken the commendable step of liberalizing lending rates of banks. To follow up on this step, on February 28, 1988, it issued new credit guidelines abolishing all sectoral ceilings while maintaining the requirement that banks lend a minimum of 20 percent of their total lending to agriculture. The Bank of Ghana interprets agriculture lending in the broad sense to include, beyond

primary agriculture, the processing, warehousing, and marketing of agricultural produce as well as forestry activities. Before December 1989 the Bank of Ghana will review the results of the recent liberalization on credit policy and determine in consultation with the IDA whether the floor on agricultural lending should be maintained.

To ensure that refinancing facilities, special lines of credit, and other special credit schemes are used only in exceptional circumstances, the Bank of Ghana will prepare criteria and mechanisms for their use. These criteria should ensure that such credits are employed only when it is clearly established that there is a market failure preventing funds from reaching disadvantaged or priority groups and that the most appropriate way of dealing with the market failure is through a special line of credit. If and when such credit schemes are used, they will be kept to a minimum, and their costs will be budgeted and made transparent. Finally, using similar criteria, the Bank of Ghana will review the Credit Guarantee Scheme and in consultation with the IDA determine whether the scheme should be wound up. In the meantime the scheme will not issue any further guarantees.

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

Money market. The emerging money market in Ghana, the principal institutional member of which is the newly established CDH, is laboring under the difficulty of an inadequately defined operational and regulatory environment. The indicative list of problem areas for the money market, and the CDH in particular, covers a wide spectrum. These problems would be addressed through the preparation and subsequent implementation of a priority reinforcement plan, to be implemented before February 1989, including the drafting of a Statement of Operating Policy for the CDH to be endorsed by the Bank of Ghana and developed after careful consultation with banks, the Bank of Ghana, and CDH management and supported by technical assistance financed under the proposed credit. Speed would be

an important factor to avoid a loss of impetus in the CDH's development. Meanwhile, pending the implementation of the reinforcement plan, the CDH's activities would be expected to be on a modest scale and limited principally to facilitating overnight transactions between banks and channeling of funds between the banking sector and the Bank of Ghana.

Capital market. The concept of establishing a capital market in Accra, probably through the ASM, has been fostered for some time by the notion that a strong demand exists for such services from potential investors and corporate issuers. Quantification of these factors will always be imprecise, but it is necessary for the foundation of a capital market to be as secure as possible. Accordingly, an assessment of the likely demand for and supply of quoted securities should be made covering the primary and secondary markets. This assessment would be undertaken in a study financed under the proposed credit, which in addition would cover the following areas: (1) design of a package of suitable incentives to attract both investors and potential corporate issuers; (2) design of an adequate regulatory and institutional framework to generate users' confidence and prevent financial abuse; and (3) assessment of the suitability of establishing a specialized financial institution providing venture and development capital. In the meantime, and pending the review of the study's outcome, no substantial action should be undertaken leading to major institutional changes in capital-market-related institutions (the ASM, the National Trust Holding Company, the proposed Capital Issues Commission).

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

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

credit extended to directors' interests by subjecting them to similar exposure limits based on the bank's capital.

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

Regulations will specify the format and content of audit reports and the minimum scope of audit reviews. Uniform accounting and auditing standards and prudential reporting requirements will also be established. The accounting standards will include guidelines for the review and classification of loan portfolios, the treatment of interest on nonperforming loans, and provisioning for potential loan losses. To assist in establishing these standards and reporting requirements, the project would finance the services of an international accounting firm.

A technical assistance program is also proposed for the purpose of establishing a credit clearinghouse, a complex undertaking requiring a technical adviser to consult on its establishment, operation, and legal framework.

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

Banking supervision. To enable the Bank of Ghana effectively to carry out its role of monitoring and preserving the health of the financial system, the skills, training, staffing, and methods of its Bank Examination Department must be strengthened. To this end a number of steps are being taken. First, the banking supervision experts are in the process of being recruited to serve as technical advisers to the Bank of Ghana. The proposed technical assistance program includes the terms of reference of the banking

supervision experts, whose assistance is critical to attract and retain high-quality individuals in the Bank Examination Department. Therefore, the Bank of Ghana will, in line with the overall review of compensation for civil servants as part of the Structural Adjustment Program, reassess staffing and compensation in conjunction with the possible reorganization of the department.

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

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

Bank restructuring. A large number of Ghanaian banks are facing severe financial difficulties, which are threatening their liquidity and solvency and thereby the stability of the financial system overall. This is particularly the case of the three development banks but to a lesser extent also of some major commercial banks. This situation was attributable to inappropriate sector policies and regulations affecting the operation of the banks in the past, inadequate banking supervision by the authorities, internal weaknesses on the part of the banks themselves (in particular deficient management teams and poor procedures and controls), as well as the massive devaluations in recent years, which have considerably increased the corporate sector's indebtedness and reduced its capacity to service its debt to the banks, exacerbating the banks' portfolio arrears.

The government realizes the critical need to restore the financial health and operational capacity of the distressed Ghanaian banks. Comprehensive diagnostic studies by international auditing firms have been carried out for the three development banks and six major commercial banks to determine accurately their financial and operational condition and the appropriate remedial measures required. These audit reports constitute the first step in a review process that would determine for each bank its prospects for future viable operation and restructuring requirements. External audits under the aegis of the Bank of Ghana will be repeated for the coming two to

three years until such time as the Bank of Ghana's examination department has been satisfactorily strengthened.

The basic principles that are to govern the restructuring of the banks have been agreed between the government and the IDA. The systematic review of audit reports by the Ghanaian authorities and the IDA will provide a basis for deciding on a future course of action (recapitalization/restructuring, merger, liquidation) for each bank. The eventual decision to recapitalize an individual bank will be based on a realistic assessment of that bank's prospects for viable operation within a reformed banking system more liberalized and competitive and with much reduced reliance on government/Bank of Ghana funding and other concessional funding.

This will entail a three-phased process of which the first step would be the preparation of detailed business projections for at least a five-year period based on realistic assumptions of future operations. The process by which these projections would be undertaken would involve consideration of fundamental issues such as sectoral specialization versus universal banking, the options of mergers and liquidations, and the degree of appropriate state financial support. Once satisfactory projections are obtained for an individual bank, a specific restructuring plan will be prepared for it, stipulating the arrangements (operational, financial, managerial, legal) for the bank's future operation. Monitorable steps for the implementation of the restructuring plan will be embodied in a performance contract to be signed between the government and the Bank of Ghana and the bank, setting out the respective obligations and commitments of each party. All restructuring plans for individual banks will be sent to the IDA for review and agreement before their implementation.

In addition to immediate safeguard measures to be taken as necessary so as to arrest further financial deterioration (that is, discontinuation or curtailment of new lending, concentration on loan recovery, reduction in operating costs, and reconciliation of accounts), specific modalities will be worked out to settle the accumulated deficits involving an appropriate mixture of cash injections and noncash adjustments, in particular (1) rescheduling or conversion of external and government/Bank of Ghana loans to banks and (2) transfer to the government of banks' portfolios of nonperforming loans to state-owned enterprises or those guaranteed by the government. Beyond internal measures at the level of each individual bank, arrangements for loan recovery might include the transfer of the banks' nonperforming loan portfolios to a separate entity (collection agency, managed fund, restructuring fund) or their sale at a discount.

Financial requirements for restructuring Ghanaian banks (both for resorbing the aggregate deficits of the whole banking system and for recapitalization of selected banks) can only be roughly estimated at this stage, pending completion and analysis of their audits and the subsequent decision-making process leading to their recapitalization or restructuring.

Initial estimates indicate that overall needs would approximate U.S.$28 million. Of this amount about U.S.$40 million could be met with th conversion into quasi equity of loans from the government and the Bank c Ghana and external lenders to the banks (principally the developmer banks) and U.S.$20 million through the repurchase by the government c nonperforming loans to state enterprises.

Corporate restructuring. As evidenced by the banks' audits available t date, a number of Ghanaian enterprises, particularly those with foreig debts or depending largely on imported inputs, are in need of bot physical and financial restructuring, in the aftermath of recent massiv devaluation, high inflation rates, and adjustment policies (trade liberaliz tion, reduction in effective protection). This situation warrants the consic eration of a nationwide program for corporate restructuring, the basi objective of which would be to offer comprehensive financial package linking future debt repayments to the cash generation capacity of indivic ual firms, using such instruments as debt-equity swaps, rescheduling c remaining debt over longer maturities, interest recapitalization, parti writeoff of accumulated penalty charges, and injection of fresh money fo increased liquidity and new fixed assets. Significant managerial and oper tional restructuring would have to be considered as well. Restructurin will be selective and confined to those enterprises temporarily in financi distress but with clear medium-term prospects for profitable operatio

The provision of technical assistance and expert guidance to the bank and the enterprises will be needed for the design as well as the implemer tation of restructuring proposals. Although the responsibility for enterpris restructuring should normally rest with the banks, the magnitude an complexity of the problem appear to require putting in place, at th country level, an institutional framework that would (1) generally overse the implementation by the banking system of the nationwide enterpris restructuring program; (2) refinance a part of the restructuring credits an investments by the banks; and (3) provide the technical assistance r quired. The government has requested the IDA's assistance in initiating study toward the design and establishment of a corporate restructurin program along the foregoing lines.

Rural finance. The government places a high priority on improving th efficiency of rural financial mechanisms to support economic, particularl agricultural, activity in rural areas. Financial intermediation in rural area however, requires special treatment because of the informal nature of th financial intermediaries that operate there and the reluctance of form financial institutions to undertake high-cost, high-risk intermediation acti ities in rural areas. The government is therefore conducting two studies c the rural financial subsector with the support of the IDA. The first will be comprehensive study of the entire range of rural financial intermediatio

required for the rural population. The second will focus on a diagnosis of a sample of rural banks (ten to fifteen) to provide the basis for the Bank of Ghana to formulate a program of action vis-à-vis those banks. These two studies together will be used to design a sector-specific action program, to be supported by a forthcoming rural finance project, which will be fully consistent with the thrust of the present financial sector adjustment program.

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

Justification and Risks

Justification. An efficient, broadly based financial sector, with an effective banking system at its core, is necessary to provide support for the continued structural adjustment effort. Ghana does not yet have this. The formal financial system is at an early stage of development and has been handicapped by significant institutional weaknesses, limited mobilization of financial resources, and deficiencies in credit allocation, all of which have constrained the supply of credit to the productive sectors.

The initial action program seeks to address these handicaps. It aims to strengthen the financial institutions, expand the scope of the formal financial system, and improve the efficiency of financial intermediation in Ghana. Its emphasis is on priority policy and institutional reforms necessary to overcome the key constraints or imperfections in the financial system that are hindering the flow of funds to the efficient productive sectors, thus limiting investment and production responses to the continuing adjustments of trade and incentive policies. Increased efficiency of the financial sector will thus enhance growth, both by increasing savings and by channeling them to higher-yielding investments. The enhanced soundness of the banking institutions, which will be pursued through their

restructuring and training programs for banks' employees, together with the proposed amendments to the banking law and other relevant regulations and the improvement in the supervision and surveillance of the banking system by the Bank of Ghana, will increase confidence in the banking system, thus inducing its further growth.

The credit will also address the development of the money market and capital market, which together with an initial program aiming at restructuring the corporate sector should both contribute to a broadening of the financial system and stimulate private investment. In addition, the development of the profession of accounting and auditing and improved accounting systems will in the long run improve the government's budgetary control and improve monitoring of the performance of state enterprises and tax collection. In the private sector efforts at productivity improvement and restructuring will be facilitated.

Risks. The main risk relates to the inherent complexity of undertaking a sectorwide restructuring of the banking system, which requires not only the strong commitment of the Ghanaian authorities but also the full cooperation of the banks' management. Other risks include the timely and adequate availability of resources and the strain the project will place on the country's implementation capabilities. These risks are, however, mitigated by (1) the government's commitment to undertake banking restructuring on a sound basis, in accordance with principles formulated in consultation with the IDA, and to seek the IDA's agreement on individual restructuring plans before their implementation; (2) the tranching of the credit, which would further ensure satisfactory progress in the implementation of the sector reform program overall and of banking restructuring in particular; and (3) finally, the sector reforms contained in the action program, in particular the recent liberalization of interest rates and the proposed improvement of the regulatory framework and strengthening of central bank supervisory functions, which are expected to go a long way to ensuring the competitiveness, efficiency, and soundness of the banking system in the future.

In Barber Conable's absence, two brief presentations were delivered to the conference that drew upon both the preceding report and circumstances in the financial sector of Ghana. Those presentations appear in this chapter as Addenda I and II.

Jacques Toureille

Addendum I

Because you have all read the president's report on Ghana, I shall be very brief in describing the main components of this program and its structuring.

The program had five components. The first consisted of two policy measures undertaken early in the process. All interest rates were gradually liberalized and are now fully determined by the market. And credit targets for banks were reduced from eight categories to one, that for agricultural lending. The definition of agricultural lending is extremely broad, which means that it does not really constitute a constraint for the banks.

The second area of concentration was the introduction of fundamental changes in banking regulation dealing with capital adequacy, lending limits, and auditing and accounting standards. The lengthy discussions that resulted in these changes involved not only the regulators or the central bank but also the banks themselves. It is very important that the banks are involved thoroughly and continuously in the reform of banking legislation. Allowed to speak up and share their concerns with the central bank, they are more likely both to influence and to understand the legislation and, in consequence, to abide by the rules.

The third component had to do with implementation of this legislation. Obviously, it is one thing to reform the legislation but another thing to implement it properly. In Ghana the enforcement of banking regulation had been extremely weak; so a lot of effort was given to strengthening the supervisory function of the central bank, particularly strengthening the examination department, through the introduction of revised procedures

for on-site and off-site supervision. This area, at least from what we have seen, is too often neglected in Africa and elsewhere. The off-site report has now been standardized in Ghana, and the information contained in those returns is being computerized and processed and some of it fed back to the banking system.

The fourth area—restructuring of the banks—is still not fully addressed. Ghana is a small country. The financial system is small. It has eleven banks. Seven of these eleven banks were severely distressed. Some of them were, in fact, totally insolvent. The Ghanaian government is now addressing this issue. It is obviously a difficult task, and it will take time. Some steps have been taken already. The first step, obviously, is to decide what to do with the nonperforming portfolios. In Ghana some banks had portfolios containing about 60 to 70 percent nonperforming loans. The measures that are required by such a situation are quite dramatic. The banks cannot really deal with that kind of issue by themselves. Some institutional mechanisms are needed that will help the process to operate more efficiently.

The fifth and final component of the Ghanaian program is to support its measures with physical assistance, training, and relevant studies.

Though implementation of the Ghanaian program commenced in 1987, the exercise started in 1985. It took about a year and a half to complete the study of financial conditions in Ghana and then about another year to devise the program and get it adopted by the various authorities.

Though the program is extremely complex, it does not address many issues that might have been incorporated. Included in the program were principally those measures that could be taken very rapidly and that were expected to have a limited impact on the system and on the undertaking of the broader program of the government.

Areas still to be addressed include some issues that need much more careful thinking because the solutions are not obvious. The first is the monetary and credit policy, which at present is not very good. The growth of the monetary aggregates is being controlled essentially through bank-by-bank credit ceilings. This is not a very efficient tool. One of its many drawbacks is that it discourages competition among banks. Therefore, this area has to be addressed much more thoroughly.

The second area that has not been addressed so far is whether the institutions should move toward more specialization or less specialization. Right now Ghana has six commercial banks, two merchant banks, and three development banks. The development banks were allowed to do more commercial banking some years ago, and there is nothing preventing commercial banks from lending to the corporate sector. Obviously, neither the liberalization of interest rates nor the despecialization of the specialized institutions has produced much effect. Therefore, there is a big question mark here. First of all, should one provide a framework for

moving toward more specialization or less specialization, and, second, what should be included in this framework?

The third area where we have a big question mark is term financing. There is no term financing to the corporate sector. A lot of things have been tried, including, again, the liberalization of interest rates. Banks have been encouraged, letters of credit have been provided, to try to step up the pace toward more term lending to the corporate sector. Specific institutions have been set up, and specific projects are being developed. But, altogether, positive effects have been extremely limited.

A fourth area unaddressed by the program is the lack of integration between the formal and informal sectors. There are certainly a lot of reasons in Ghana for having a hard inequity between those two sectors, including the total lack of confidence that many people had. Many measures have now been undertaken to try to reverse the trend, to restore confidence in the banking system, to restore confidence in government practices. A lot of ground still needs to be covered in the public sector.

Finally, I would like to discuss several prerequisites for this operation and then some of the lessons that we have already started to learn. Such a program might seem simple, but it is, in fact, complex. We first of all undertook a thorough sector review of the conditions in Ghana, and it has been extremely useful. The sector review took about eighteen months. It addressed most of the aspects of the financial sector, from government policies to various institutional areas, and has been extremely useful as a base for developing the operation.

A second important prerequisite was our development of a close cooperative environment with the authorities, one that both induced and supported their commitment to the program. This is simple to say, but it is extremely difficult to achieve because a lot of interests are often pulling in different directions. If one wants to ensure the success of such a program, one had better make sure that most of the forces are pointing in the same direction.

The third area, which very often has been overlooked in the past, is the need for an adequate macroeconomic environment. Maybe some of my friends working in Latin America have had different experiences, but in the countries in which I am working, it is clear that if the inflation rate is too high or if the foreign exchange system is not working properly, we will not achieve much financial sector reform. Those things have to be addressed thoroughly before we can introduce significant reforms in the financial sector and before we can be sure that the institutions are going to function properly and be healthy.

The fourth item on the list of prerequisites is that the sequencing of actions has to be done very carefully. Otherwise, we might have surprises. The undertaking of an action program is a lengthy process. Some actions have to be taken up front to get them out of the way, to make sure that

things are being done according to plan, so that we can move on to the next issue.

The time span is often much longer than anticipated. It would be overambitious to think that we can undertake an appropriate reform of the financial system in the African environment within a period of less than, I would say, five years. I do not think that we can achieve that in one operation. We have to have several in sequence.

The last thing is to be as flexible as possible and to be open to different solutions. Of course, from a theoretical point of view, the remedies are usually simple and well known. But every situation is different, as I have seen in the countries in which I am working. We have to be prepared to come up with different solutions, different ingredients, different sequencing. We have to tackle the problems with a very flexible mind, keeping in mind that a lot of the reforms we are undertaking are interrelated and that, therefore, if we do not address something immediately, we have to take account of the impact and make sure that we do address it in proper time.

M. G. Sri-ram Aiyer

Addendum II

Generally the menu that has been adopted in financial sector reform programs has included interest rate and monetary policies, improved regulations to enhance the prudential regulations and strengthen supervision of and by the central bank, and restructuring of the banks

Having seen this process at play for three or four years in Ghana, we see that a key difficulty in meeting the goal of positive real interest rates is the high inflation that seems to persist in the African countries that have launched adjustment programs. We all know that deeply negative real interest rates lead to rapid capital flight, disintermediation, and avoidance of any more risky investments. The adjustment programs call for attracting investment to areas of comparative advantage, but that goal is delayed through this process. One of the big problems I see in the African countries that I have worked on is the loss of investors' confidence, the rise in inflationary expectations, and the spiraling effect of rising prices, which frightens the policy makers, who tend not to want to let interest rates rise, to let real rates be positive, because of legitimate concerns in many cases.

We have not seen as yet a restoration of investors' confidence, even in countries that started adjustment programs some years ago. Other than export agriculture, we see only investments in activities of low risk and high return, such as gold mining in Ghana.

To me, it seems that the most important action is restoration of price stability. It is central to being able to implement financial sector programs

that are meaningful and manageable. It is also central to private sector development.

The second element is prudential regulations and supervision. Having seen these in operation in a few countries, we see that their common feature has been that regulations on near-banks can be discussed and agreed on, but generally the regulations (on capital adequacy, for example) are outdated. Most central bankers are prepared to implement the regulations. They are also often ready to accept technical assistance to strengthen the central bank's ability to supervise the primary banks. This is a good stopgap measure until training and restaffing are pursued, but that is the easy part.

The hard part is bringing toward compliance banks that have 70 percent of their portfolios as overdrafts, have heavy concentrations of their loans to public enterprises, and, even in rather simple areas like accounting, have different treatments from bank to bank. The new regulations call for consistency of format, consistency in treatment of overdue interest, and so on. It is difficult to get this whole process moving as it should be for one bank alone. It is even more difficult to reclassify portfolios according to the risk they represent, the quality of the assets, the quality of the securities, and other pertinent considerations. It takes a lot of work and a lot of time. We have consistently been overoptimistic about how much time it takes.

The third area is restructuring. It is really troublesome, but in most of the countries in which we have worked, the losses invariably end up being owned by the state. This is disconcerting because the nonperforming portfolios include private sector losses, and the model that this represents, as seen in the U.S. savings and loan failures, is really worrisome. But this is the only route we have found. If there are some other ways that people can think of for sharing the losses, this would be an interesting area for discussion and maybe for application in reform programs as they unfold.

Another area in which we do not have enough information is on ways of disposing of nonperforming assets to reduce the net losses to the government. We talk about taking the nonperforming assets and the corresponding liabilities and somehow parking them somewhere, a recovery agency or someplace like that, but means of disposing of these are largely untried. We would be very interested in sharing whatever experiences exist. One interesting case was the Philippines, where an asset privatization trust was set up. But there seems to have been a market because the assets largely held their value even when they started to be sold. When the same thing was tried in Gambia, the value of real estate just plummeted when the few buildings taken over began selling. So far we have not found good, replicable methods by which repossessed assets can be reasonably disposed of without considerable losses, and any ideas on that front would be welcome.

We are finding a ready recognition of the need to change management, but when it comes to getting new management in place, readiness recedes. We immediately get into political areas. I think there is a supply problem. There is not an abundant number of good managers available in Africa.

The cost of bringing in managers from abroad is very high. Even with outside managers, the experience is not uniform in their ability to resist government pressure. Governments can be very dominant; we need government will to have a financial system in which the banks are allowed to function as sound businesses.

The last issue is, What kind of financial system can one expect in fifteen or twenty years in the smaller African economies? Can one see effective functioning banks in small economies that can compete and deliver services at low cost, or should one be thinking about capital markets that are more regional?

Appendix

TABLE 5.1

Financial Sector Adjustment Credit, Assets and Liabilities of Banks, 1975–1987 (million cedis at end of period)

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	Sept. 1987
Cash on hand	39.6	51.1	186.7	312.1	196.8	469.4	461.6	760.7	1,401.1	2,294.3	3,431.8	3,631.4	7,338.8
Balance with BOG and other banks	357.8	504.1	618.5	1,358.6	1,762.8	1,965.0	1,902.9	3,421.7	4,424.3	5,514.3	12,732.1	24,834.0	26,850.5
Treasury bills, stocks, and bonds	216.3	341.5	578.5	764.0	1,111.8	1,689.0	2,300.8	4,233.7	6,527.8	6,380.6	8,634.2	11,531.1	10,784.0
Commercial bills	118.2	155.8	189.4	302.3	364.8	35.0	41.1	420.2	402.1	48.2	2,071.7	1,064.3	443.3
Loans and advances	604.1	776.9	1,097.9	1,543.5	1748.8	2,382.8	3,163.4	3,876.5	6,423.4	12,258.0	22,498.6	40,926.3	52,958.5
Other assets[a]	248.2	288.9	458.7	885.4	1,506.0	1,432.9	2,356.3	5,359.6	8,477.2	15,204.9	15,342.6	30,311.9	57,907.7
Total assets	1,584.2	2,118.3	3,129.9	5,165.9	6,691.0	7,974.1	10,226.1	18,072.4	27,655.9	41,700.3	64,711.0	112,299.0	156,282.8

Demand deposits[b]	598.9	833.9	1,387.7	2,393.1	2,514.5	3,019.0	3,263.5	5,749.0	8,712.9	13,238.9	21,871.2	32,920.4	35,962.6
Saving deposits	294.0	408.6	606.8	1,029.5	1,357.9	2,134.0	2,711.3	4,369.8	4,992.1	5,999.0	8,832.2	14,140.8	18,816.2
Time deposits	168.6	185.5	189.9	242.9	263.2	315.0	388.7	460.7	570.3	1,180.8	2,842.5	5,980.6	12,898.5
Balance with BOG and other banks[c]	91.4	102.5	117.0	183.3	198.2	273.4	291.3	507.3	1,772.9	3,072.5	8,285.1	11,566.4	26,210.7
Paid-up capital and reserves	113.1	147.4	183.5	275.7	362.2	460.0	440.3	882.9	2,611.5	4,395.1	3,553.8	7,358.5	8,403.4
Other liabilities[d]	318.2	440.4	645.0	1,061.4	1,995.0	1,772.7	3,131.0	6,102.7	8,996.2	13,814.0	19,326.2	40,332.3	53,991.4
Total liabilities	1,584.2	2,118.3	3,129.9	5,165.9	6,691.0	7,974.1	10,226.1	18,072.4	27,655.9	41,700.3	64,711.0	112,299.0	156,282.8

NOTE: The proportion of public sector deposits plus government deposits over total deposits is about 20 percent for 1985, 10 percent for 1986, and 15.5 percent in September 1987.

a. Excludes BOG.

b. Includes all government deposits.

c. Includes external borrowings of banks.

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

SOURCE: Bank of Ghana, World Bank.

TABLE 5.2

Financial Sector Adjustment Credit, (million cedis or ratios)

	1970	1975	1980	1981	1982	1983	1984	1985	1986	1987 (estimate)
Total GDP at current market prices	2,259	5,283	42,853	72,626	86,451	184,638	270,561	373,068	511,256	702,789
Banking system net assets[a]	573	1,745	9,862	15,393	19,930	28,147	33,129	48,591	67,397	96,129
Assets/GDP	0.25	0.33	0.23	0.21	0.23	0.15	0.12	0.13	0.13	0.14
Total bank credits	n.a.	n.a.	2,068	2,803	2,986	5,732	11,996	21,401	40,329	73,945
Credits/GDP	n.a.	n.a.	0.05	0.04	0.03	0.03	0.04	0.06	0.08	0.10
Total narrow money supply (M1)	305	1,009	6,225	10,148	12,297	18,770	26,643	43,471	64,620	100,636
M1/GDP	0.14	0.19	0.15	0.14	0.14	0.10	0.10	0.12	0.13	0.14
Total broad money supply (M2)	427	1,386	8,696	13,634	17,130	24,324	33,836	55,036	84,684	133,782
M2/GDP	0.19	0.26	0.20	0.19	0.20	0.13	0.13	0.15	0.17	0.19

NOTE: n.a. = not applicable.

a. Includes Bank of Ghana.

SOURCE: BOG and World Bank Estimates.

TABLE 5.3

Financial Sector Adjustment Credit, Money Supply

	1970	1975	1980	1981	1982	1983	1984	1985	1986	1987 (estimate)
Million cedis currency										
Notes and coins in circulation	167	524	3,897	6,552	7,488	11,435	16,234	25,327	34,735	40,358
Held by commercial banks	16[a]	39[a]	469	607	761	1,398	2,291	3,430	3,495	7,039
Total held outside banks	151	485	3,428	5,945	6,727	10,037	13,943	21,897	31,240	33,319
Demand deposits										
With primary banks	155	523	2,090	3,310	4,048	5,477	8,778	13,240	17,736	19,826
With secondary banks	n.a.	n.a.	651	865	1,419	2,717	3,786	7,550	13,609	16,267
With Bank of Ghana	n.a.	n.a.	56	28	102	539	136	785	2,034	7,276
Total demand deposits	155	523	2,797	4,203	5,569	8,733	12,700	21,575	33,379	43,369
Total narrow money supply (M1)	306	1,008	6,225	10,148	12,296	18,770	26,643	43,472	64,619	76,688
Time and savings deposits:										
With primary banks	121	378	1,862	2,614	3,633	4,084	5,108	8,405	13,951	19,903
With secondary banks	n.a.	n.a.	610	873	1,200	1,469	2,085	3,160	6,033	11,120
Total quasi money	121	378	2,472	3,487	4,833	5,553	7,193	11,565	19,984	31,123
Total broad money supply (M2)	427	1,386	8,697	13,635	17,129	24,323	33,836	55,037	84,603	107,811

NOTE: n.a. = not available.

a. Primary banks only.

SOURCE: Bank of Ghana.

TABLE 5.4

Financial Sector Adjustment Credit, Deposits and Their Structure, 1976–1987

	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	Sept. 1987
(In million cedis)												
Demand deposits	765.2	1,294.7	2,206.0	2,334.5	2,777.3	2,958.8	5,476.1	8,160.4	12,635.6	20,881.8	31,610.4	34,419.5
Savings deposits	408.6	606.8	1,029.5	1,367.9	2,134.0	2,711.3	4,369.8	4,992.1	5,999.0	8,832.2	14,140.8	17,816.2
Time deposits	185.5	189.9	242.9	263.2	315.0	388.7	460.7	570.3	1,180.8	2,842.6	5,980.6	13,989.5
Total	1,359.3	2,091.4	3,480.4	3,965.6	5,226.3	6,058.8	10,306.6	13,722.8	19,815.4	32,556.5	51,731.8	66,225.2
(In percentages)												
Demand deposits	56	62	63	59	53	49	53	59	64	64	61	52
Savings deposits	30	29	30	34	41	45	42	36	30	27	27	27
Time deposits	14	9	7	7	6	6	4	4	6	9	12	21
Total	100	100	100	100	100	100	100	100	100	100	100	100

NOTE: Includes primary and secondary banks and for both private and public sector.
SOURCE: Bank of Ghana.

TABLE 5.5

Financial Sector Adjustment Credit, Total Bank Credit to Private Sector and Public Enterprises by Sector (in million cedis)

	1980	1981	1982	1983	1984	1985	1986	Sept. 1987
Agriculture, forestry, fishing	412.4	655.0	688.6	2,012.9	3,779.1	5,207.6	7,476.3	9,447.1
Export trade	69.4	172.9	67.2	92.0	187.4	490.0	1,451.2	2,255.6
Manufacturing	472.0	508.3	635.2	866.6	3,288.4	6,046.4	10,800.4	15,952.5
Transport, storage, communications	193.5	215.2	201.8	331.3	653.7	1,154.3	2,021.5	3,451.2
Mining, quarrying	55.0	137.1	243.0	416.3	497.5	960.2	1,437.3	2,430.5
Import trade	34.4	47.6	42.4	107.4	307.7	990.7	2,931.4	4,476.4
Construction	289.1	411.9	511.2	796.6	1,273.9	2,017.6	3,899.4	5,052.9
Commerce and finance	246.0	321.1	293.5	683.2	1,175.0	2,820.3	5,042.0	5,265.7
Electricity, gas, water	116.0	44.2	42.2	49.6	21.4	37.8	46.1	83.8
Services	108.5	157.1	175.0	250.8	533.7	1,224.8	2,611.5	3,449.3
Miscellaneous	71.5	132.3	86.0	125.4	277.9	451.2	2,611.5	1,144.1
Total	2,067.8	2,802.7	2,986.1	5,732.1	11,995.7	21,401.1	40,328.6	53,009.1

SOURCE: Bank of Ghana.

721

Sergio Bortolani

Comment

I would like to make some comments based on this presentation on Ghana and also on my recent mission in Somalia, where I spent five weeks in a technical assistance program to the financial institutions.

I found the program of Ghana very comprehensive, well articulated (probably even too much), and very optimistic. I hope that the measures that are going to be taken will be successful. Probably in Ghana there is more will to cooperate. I would like to stress this point, because without a willingness to cooperate on the part of the local authorities, any technical economic or financial measures are likely to be ineffective, or, at the best, they can produce some beneficial effects in the short run but none in the medium run.

Willingness to cooperate requires a strong and determined government committed, first of all, to honesty and to a search for efficiency. How many governments are like that in Africa and, in general, all over the world? This morning two bad words have been mentioned often: corruption and mismanagement. When we face situations like that, programs of adjustment or restructuring of the financial system become very difficult to implement.

Many of these countries have a corrupted ruling class that destroys resources and leaves the people in poverty. It is a scandal that public money from bilateral and international agencies goes into the hands of some corrupted senior officials, and we become coresponsible for this. In my view, in all these cases technical measures provide almost nothing.

We can prepare a very good accounting manual for a bank, but then the bank managers will not put it into practice. We can provide budgetary control procedures for the ministry of finance, and they remain just a nice report. The IMF has sent various missions to the ministries of finance for that purpose, and the results have been very poor.

We must ask for a minimum level of commitment (the famous "conditionality," a word that Africans do not like). The present report on Ghana mentions that the main risk of the program relates to the complexity of undertaking a sectorwide restructuring of the banking system, which requires not only the strong commitment of the Ghanaian authorities but also the full cooperation of the bank's management. I totally share this view. The big challenge of these programs is to have the commitment of the government and the cooperation of the relevant financial institutions.

But there are various reasons why financial institutions do not cooperate even though the government, at least publicly, cooperates. One reason is that the operation of the bank is completely out of order, and therefore it is vain to expect that anyone can be of any help even if they are so disposed. Another reason is that information is purposely not given because it may reveal the disastrous state of the art: the fine technique of postponing and passing the buck is extensively applied in these cases. The management of the bank does not understand the objective of this intrusion and considers it useless and a waste of time. There is no real will to change because any change can dangerously alter the present leadership. Finally, no one is motivated to increase his effort, and none are punished for not doing so.

So an important precondition for the success of any program is to link the rehabilitation plan to effective control of top management decisions by a team of external experts. I say a team, not just one or two persons, able to resist government interference and to eliminate or reduce corruption. In my experience in Africa, I found that African banks do not lack good managers. But it is much more difficult to be a good manager or a good entrepreneur in a context where corruption and mismanagement are widespread.

Only by ensuring the cooperation of the banks and the government can technical measures be effective. That is why I said at the beginning that I am rather skeptical about the optimism of the program concerning Ghana.

-123

Discussion

Michael Sarris: A number of trade-offs have been presented by these contributors. For example, there has been some expression of the need to go slow. At the same time it appears that there may be a minimum amount of reform that must be undertaken before we can expect any kind of results. So the question becomes, How do we balance those two?

There is also the thought that to get the institutions functioning again, we have to clean out their portfolios. But there is a trade-off between that and prodding them into trying to recover some of those losses. Is it wise to create a precedent that every time they get into trouble, somebody comes and bails them out?

There is the important question of how the cost of restructuring is to be distributed across economic entities and also across time. The IMF would have a view on how much of the loss is being reflected in that year's budget.

There is the question of commitment. Should we even embark on a major restructuring unless we have a clear political commitment; unless, for example, we can identify a strong personality within the government who is going to see it through? Then there is the other question that Jacques Toureille mentioned earlier, namely that it is all very nice to say let's get rid of credit ceilings, but what other instruments are available to make sure that the money supply does not grow too fast for what we are trying to achieve?

How do we manage the transition from an overregulated system where interest rates and credit ceilings are the main monetary policy instruments

to a system where we have more general, more neutral instruments that we have to create?

These are some of the questions that have been raised. I am looking forward, now, to learning the answers.

Jerry Wolgin: I wonder if any of the preceding contributors is able to set forth a list of prerequisites that must be in place before a financial system can move from direct control, where each bank has a credit ceiling, to a system that employs indirect mechanisms. Prerequisites were mentioned without being identified. Has anyone thought through what has to be in place before moving to indirect controls?

A second question has to do with mobilizing domestic resources in Ghana. I understood the speakers to say that the financial system was liberalized with respect to interest rates. Is it true that interest rates are positive in real terms? And if they are, why aren't we beginning to see more mobilization of domestic resources?

Reinhold Van Til: Real interest rates in Ghana are negative—because inflation is coming down somewhat. On the issue of direct and indirect means of monetary control, I think it is a misperception that direct controls necessarily inhibit, so to speak, the allocative function of banks or institutions. That is not the case, because even in the programs that the fund normally formulates with respect to direct controls, there would still be room—sufficient room—to attract resources and allocate those resources. So the financial mobilization function is not really at stake.

As to the question of prerequisites for instituting indirect controls, one of the most important things, probably, is a stable relationship between reserve money of the central bank and the total money stock. If that is a stable function, then the central bank balance sheet can be controlled. But such a relationship requires two things. First of all, it requires recognition that such a stable relationship may itself vary over time, being subject to all kinds of seasonal factors that most people, including those who are supposed to formulate monetary policy, are not aware of. Second, it assumes that the central bank can control its balance sheet. We often see that central banks are not involved in direct lending. For example, in Ghana they are not involved in copal financing. So it is often necessary that central banks get out of any commercial activities to be able to control reserve money.

Jerry Wolgin: If real interest rates are negative, does the bank program envision a time or a necessity or a conditionality or anything toward moving toward positive real interest rates as part of restructuring?

Reinhold Van Til: I am not sure what the bank program envisages. The occurrence of negative real interest rates is a phenomenon that has happened over the past two or three years. There was a period when inflation came down very quickly and nominal interest rates were raised.

One of the interesting things about the liberalization of interest rates in Ghana is that nothing has basically changed in the structure. If anything, deposit rates came down. Margins of commercial banks increased. The question really is, Is it simply the oligopolistic structure, a decision of its members to go out and mobilize savings?

I have heard here that the mobilization of savings in Ghana has not been very successful. I think that is a bit of an exaggeration. If we look at the development of real savings, it certainly has not declined. There has been a small increase since about 1985. So it is not that bad, but it is at the same time quite clear that there is collusion in the system. What does this relate to? Maybe partly to a comfortable profit position of some of these banks.

Jerry Wolgin: Are interest rates market determined?

Reinhold Van Til: Yes, they are.

J. O. Sanusi: I have three very brief questions. First, Mr. Toureille spoke of eleven banks in Ghana and said seven of them are distressed—what ratio of the banking operations in Ghana do these seven banks represent? It is possible that the four that are not distressed control the bulk of the economy.

Second, you spoke about the lack of confidence in the banking sector in Ghana. I would welcome an explanation of why this is so; Ghana is one of the countries in West Africa where there should be good quality management because the standard of education is comparatively high.

The third question refers to the very pertinent point made by Mr. Aiyer. This is the fact that in spite of all the restructuring of economic measures that has been carried out in a lot of African countries, the investors' confidence has not yet been restored, and this is very vital. Unless one has the investors' confidence and can increase productivity in the continent through well-increased investment, the question of inflation, the question of what happens to the value of money is quite clear. Unless goods and services are produced, there will be scarcity, and so there is nothing one can do over time; without increased investment and productivity one will continue to have increased inflation.

It is not only the confidence of investors from outside but the confidence of the investors inside, and that is why we have capital flights. The speakers might want to address briefly what are the things that need to be done for these countries to restore the investors' confidence because they have been acting as advisers all along.

Jacques Toureille: I do not think there would be a point in going into too much detail on which banks are sick or not sick. The sickness was very extensive, or is very extensive, and is affecting some of the major banks. Some large banks have been affected both in the commercial and in the independent sectors, and the overall distressed portfolio is very large. I do not remember the figures exactly, but I believe the nonperforming

portfolio across the board is in the range of about 30 or 35 percent. It i very large. It is not limited to small institutions; it is not limited t development finance companies. It is affecting some large commerci banks, and the assessment, though very thorough, is not a full assessmen

The assessment is based on diagnostic studies that have been unde taken by independent auditing firms. But as one knows, it is only one ste to look into the assets of a bank. When we go a bit more carefully and mor thoroughly and review the portfolio—and this will happen in the secon phase of the program—maybe we will discover that the situation is eve worse than what we have seen in the first stage.

A second relevant factor is the importance of foreign capital in th banks. Ghana is a country where foreign shareholding in a bank is allowe Some banks are fully owned by foreign interests, and a majority of th capital of some major banks is owned by foreign interests. Nonetheles across the board, the private shareholding, including foreign shareholdin is very small. In other words, foreign shareholding is concentrated i relatively small banks.

There was a question on the lack of confidence. Maybe Mr. Aiyer woul like to comment on that. But what I was referring to was essentially th political climate in Ghana. For a long time it was not favorable to privat initiative and banking activities as a whole. Repeatedly measures wer taken against banks or against private initiative, and as in other countrie the banks are very often the scapegoats whenever something goes wron They are being accused of doing a lot of bad things, of making a lot of larg profits, undue profits, profiting from the situation.

When, for example, interest rates are liberalized—this is true of othe countries as well as Ghana—we see that interest rates rise on the lendin side but not so much on the deposit side, and immediately people criticiz the banks.

So that is principally where I was talking of lack of confidence and th need of restoring this confidence. A related issue is the secrecy of bankin activity. In the past the attitude of the government had been to crack dow on people having money in the banks, thereby provoking large flights deposit money or discouraging people with money from depositing it i the banking system.

M. G. Sri-ram Aiyer: Looking back, I suppose confidence in Ghan was undermined first of all by the economic policies, principally th exchange rate, which offered no incentive for producers to sell their outpu within Ghana. As more and more of the trade took the parallel mark route—and that continued for awhile, and there was the interest—th propensity to import continued to stay high. The government took som heavy-handed measures, including seizing things. If banking is a function confidence and confidentiality, both these were struck one full blow i Ghana.

First of all, all accounts above a certain size were frozen. Large-denomination notes were suddenly demonetized overnight. And people's accounts were examined on the grounds that if they had money above a certain amount, it must have been made on somebody's back, without looking at the source of the problem, which was the economic policies. Of course, money left the banks even faster after these interventions and returned far less rapidly, if at all.

With regard to restoring confidence, I thought Mr. Sanusi was asking why it is that in Africa, in spite of economic reform that has been sustained for some period of time, one has not seen a restoration of domestic investment or foreign direct investment and domestic capital continues to leave the country. This is a very difficult problem, and I wish we knew the answers. I was only expressing my concern, because all the symptoms suggest continuing erosion of confidence, especially if we look at inflation rates, except in some countries where they are coming down.

Nonetheless, some thoughts that might positively contribute to the effort to restore confidence are suggested by those who lack it. Both outside and domestic private sector investors very often blame the regulatory environment and the difficulty of doing business in Ghana. This is one area that merits examination. Another is the reliability with which people can do business. Businessmen generally take a long-term view, or they need to take a longer-term view. Price stability is one factor, but reliability is also important for supplies, for markets, and so on. Africa is commonly viewed as offering less reliability and more regulation than other parts of the world, and it is the same capital that is going around looking for places in which to invest.

I have read that today Malaysia stands number one among private investors, because—and this one factor keeps being cited—it takes only thirty days for an investment approval to be received in Malaysia for any investment. In Africa, however, one gets a completely different kind of picture. That is an area to work on. The more one can bring the investment climate within African countries on a par with competing countries, the better the chances would be for investment to start. Certainly there is investment in some areas that are export oriented, but one worries whether this is because it is a means of capital flight.

This is not an easy question. I wish we knew the answer. Then we could all go to work right away to fix that problem.

Alan Gelb: The Ghanaian case reveals something quite interesting about the sequencing of operations. The sequence went from the liberalization of interest rates and credit to the restructuring of financial institutions. We have seen some other cases where financial markets have been liberalized while leaving banks that were technically insolvent and their management in place. The impact has been an explosion of distress borrowing. I think Turkey is such a case.

How has this possibility been headed off in Ghana, and are there lessons for other countries and their programs? This is an important question because I think the sequence that is being followed in this program is rather a natural one, in terms of what can be done quickly versus what tends to take a long time. The problem is how to bridge the consistency between those two.

M. G. Sri-ram Aiyer: In Ghana the combined work of the fund and the bank and the government has led to what is probably a more carefully managed program, a reasonably well-orchestrated set of measures, and a consistency of direction, particularly on the exchange rate. The government has stuck the course and stayed with it. Bringing the parallel and official markets together and then opening the Bureau du Change, and so on, were important measures.

On interest rates and distress borrowing: there was distress borrowing, but there were not a lot of firms, there was not much continuing activity, and the extent of the activity rapidly declined in these firms because they were not profitable.

Anand Chandavarkar: I had a question to ask of Mr. Sri-ram Aiyer, which pertains to Ghana but is of wider applicability. At what point in the financial system do liquidity problems turn into insolvency problems, and how do performing assets become nonperforming, despite the supervisory and prudential measures of the central bank? Is this a case where the management failures of the private sector are neatly paralleled by the bureaucratic failures of the central bank?

M. G. Sri-ram Aiyer: I think that consistency of policy and good economic management are the only answers in Ghana. It is not really better management by the banks. It is not really better supervision by the central bank. The management failures were of banks, which lent, I suppose, in good measure under pressure from the government, at government behest in many cases, and to state enterprises in a large number of cases.

Governments are very ready to guarantee all these loans, or quasi-guarantee them, but the governments are not able to deliver on the guarantees. The guarantees are worth nothing. The managements knew it, but they continued to deliver credit to these entities. And then they continued to credit themselves with income, even when the interest payments were overdue for long periods, with supervisory failures certainly in Ghana.

A similar problem happened in Nigeria, but it is my impression that fewer banks are in difficulty there because the supervision was perhaps more rigorous. The managements of the banks were also better in Nigeria for a variety of reasons: there are a larger number of banks; there is more competition among banks; many banks have foreign shareholders who assist with the management; and the supervision of the central bank has

been perhaps a little more rigorous than in Ghana. They are trying to correct that in Ghana.

For the time being, though, competition between the banks is still not there, as Mr. Van Til mentioned. The system still remains oligopolistic for a variety of reasons. All of this tells us that announcing a reform program, to function freely in financial markets, is much slower than we anticipate in the beginning. It does not move with great speed, because every time we find more things that need to be fixed.

C. S. Kimei: It seems that we are all very concerned about the institutions per se, but what about creativity in the making of monetary instruments that would be appealing to African nations? There is some room for resource mobilization that would suit the requirements of an environment where inflation is very high and so forth. In Africa we find that the principal instrument available for resource mobilization is currency.

Clark Leith: I had a question relating to a section of the report that has not been mentioned thus far, the section dealing with foreign exchange risk. There is an interesting proposal here in which something would be set up in effect to absorb foreign exchange risk. I would like to try to understand that and how that is intended to work, because it is quite vague in the report.

Mohamadou Diop: A lot of emphasis is being put on price stability, macroeconomic stability, and the need to coordinate institutional development and macroeconomic constraints. I would like to know what is being done when structural adjustment policies regarding the liberalization of foreign trade, to give one example, have a negative impact on bank portfolios. How might this happen? Some noneconomic enterprises are "healthy" because they enjoy a degree of subsidy and monopoly. They may be representative of the well-performing portfolios of the banks. Bank portfolios, then, can deteriorate as a result of the tendency of trade liberalization to align local prices with international prices.

As you know, the portfolio of most of our banks is basically made up of importing industries in the consumer good industries, including food processing and textiles.

We had a debate in Senegal within the banking association, and within the trade association, with the government, and it is a dead end. The healthy banks' portfolio exposure is basically in these sectors where structural adjustment policies are leading to phasing out of some of these industries or a restructuring of them, necessitating sacrifices from the very same bank.

Of course, the situation gets worse when we are talking about banks undergoing difficulties, so that we are faced with a dilemma and with a very difficult set of alternatives, each of which is fraught with dangers. I am interested to hear what is being done about this tricky issue.

Philippe Callier: I would like to build on this remark and other comments made earlier to offer an optimistic view of financial distress.

We can argue that financial distress is a good thing for precisely the reason you suggested: financial distress appears when a long-delayed correction of overall macroeconomic or sectoral imbalances is finally attempted. The necessary adjustments cause industries that were economically inefficient to become unprofitable and to fail, with the consequence that they are unable to service their debt to their creditors. The positive aspect of this situation is that, in the future, financial and real resources will not continue to flow to these inefficient industries but will be allocated to efficient ones. Financial distress is the sign that the necessary adjustment is finally under way.

There is a corollary to this view. Even if this optimistic interpretation of financial distress is correct, it is clear that too much of a good thing may be bad for the economy's health—hence the idea that a good financial system should be designed so as to minimize the adverse consequences of structural adjustments or shifts in relative prices for the financial sector. Insulating the financial sector from these adjustments is possible only if we qualify the principle that the financial sector is the mirror image of the real sector. This is particularly desirable in small countries that are highly specialized, as these countries are likely to be frequently hit by shocks that are not necessarily the result of policy mistakes by their own governments but are simply the consequence of fluctuations in world markets.

Is there a way to break that correspondence between the domestic real sector and the domestic financial sector? It seems it could be achieved by allowing the public and the financial institutions more freedom in financial transactions with nonresidents and encouraging capital flows both in and out of the country. Financial investment abroad is sometimes labeled "capital flight" but can also be interpreted as the outcome of the healthy practice of portfolio diversification.

Alan Gelb: I would like to comment briefly on the question of private investment, an area where quite a lot of research is warranted. We appear to know very little about what determines changes in private investment.

There is a model underlying our assumptions about financial sector reform: reform the financial sector; then, as a result, cut off the links between banks and insolvent firms; cut down on distress borrowing, and increase the supply of credit to the credit-worthy firms. We will then, of course, expect investment to increase. I am not sure, however, that the world works that way. Evidence from sample surveys of countries' balance sheets suggests a somewhat different profile of the response of private investment.

For example, if we look at what happened in Brazil in 1983, or Turkey in the 1980s, or the Philippines, we will see that the private clients or the clients that stay in the system tend to bifurcate into two groups. There are

firms that are intrinsically rather strong, and there are firms that are rather shaky. Because of the uncertainty created by the adjustment programs, the firms that are strong tend to pull in their horns, and they take as much advantage as they can of their profitability to strengthen their balance sheets. So what we see is a whole group of businesses that does not invest, that want to insulate themselves from changes in the economy to survive. As a result investment by a substantial part of the industrial sector simply does not occur for some years, until the firms feel confident enough and until they decrease debt burdens enough. Therefore, in certain countries, at a time of seriously adverse conditions, quite a large part of the corporate sector is strengthening its balance sheet by cutting costs and not investing. That seems to me to be a very logical response to risk. It suggests that we should be rather cautious in expecting a response of private investment, because that simply is not how a rational, survival-oriented firm will respond.

In African countries we perhaps have less information about the balance sheets of private corporate borrowers. Perhaps there are not many of them, but this is an area where more work could be done in understanding private investment dynamics.

M. G. Sri-ram Aiyer: Mohamadou Diop raised an interesting and important point that relates back to something Alan Gelb had mentioned earlier about sequencing. There is a set of existing firms, and these firms represent an investment in human capital, and so on, and especially in Africa, we cannot write this off very easily. Indeed, the financial system mirrors the problems of these firms, because they largely lent to these existing firms.

Even in a distressed environment or an environment that is undergoing some trauma, some shocks, some firms will be intrinsically strong and capable of restructuring and being turned around. Even with the same building, those managers know how to run a firm. They did it under one set of price signals; they can turn the firm around to produce differently in another environment.

In recognition of that fact, we have in Ghana a program called a Corporate Restructuring Study to analyze the problems of, let's say, the top thirty firms. The study is to see which of those firms need to be cut off and which need workouts by the firms' owners and the managements of the banks, so that some kind of medium-term program can be undertaken to help both the firms and the banks. The investment reluctance that Alan Gelb mentioned is there. I think it would be fair to say that, for African industry, the route of the past does not hold much hope, because it was import substitution.

Good markets are getting so integrated, African borders are so porous—and they all know this—that export-oriented activity has to be the mainstay of any business. Other countries have started, and they are reaping very good returns from this change of orientation.

That is the kind of industry, I suppose, that one would expect to come from new investment. Some of the existing firms were turned around, but I would imagine that the more interesting population to see is that which emerges in response to new opportunities. Those opportunities—spawned by changes in the policy environment and accelerated by technological change—will attract foreign direct investment and domestic entrepreneurs alike. How productivity of the domestic corporate sector is encouraged, rather than discouraged, by government policies and regulations is critical, ultimately, to the health of the financial sector. Otherwise, even after the banks are restructured, unless productivity and profitability of their borrowers and depositors are encouraged, the banks could easily go back to the same hole.

As for this idea of separating the domestic real sector from the domestic financial sector, I do not know. Jacques Toureille was just whispering to me that even in very troubled environments, good banks have stayed out of trouble because they have had very strong or good management. It has happened in Oklahoma, in Texas, and in some savings and loans. Some banks have not gotten into as much trouble as others.

To the extent that I mention regional banks, they would be able to diversify their portfolios so that they are not all locked into one set of domestic economies. But I imagine that African economies have also become regional, anyway.

-133

6

Parker Shipton

Borrowing and Lending in The Gambia: Local Perspectives on Formal and Informal Finance in Agrarian West Africa

This chapter describes how rural people borrow and lend vital resources in The Gambia, a country generally considered one of the world's poorest. Many reports have been written recently on The Gambia's agricultural financial systems, from the perspective of the capital city Banjul, concentrating on governmental and other institutions (for example, Wing 1983, Bailey 1984, Ramamurthy 1986, Clark 1987). Though these documents together provide much information on the government cooperatives and other formal structures, the systems referred to in the past two decades as informal have generally been relegated to a few paragraphs toward the end: a residual category about which little is said or asked.[1]

This brief study takes an opposite approach. It emphasizes villagers' perspectives, focusing first on the systems to which they often turn first, the ones they themselves have helped create. The basic question is simple: Who borrows what from whom? But the answer is complex. Farmers are

involved in many more kinds of credit and debt in rural areas than most foreign analysts assume, involving not just money but diverse other resources as well. Rural people's multiple obligations suggest good reasons why farmers have often given low priority to repayment of institutional lenders. A broadly sketched inventory shows that some kinds of goods and services still remain hard for rural people to obtain on loan, for cultural as well as economic reasons.

Part of a broader continuing study on Gambian saving and credit, the chapter reports some preliminary field observations made in two visits in 1987 and 1988.[2] Given general disappointments with institutional finance of all kinds in rural West Africa since the Second World War, planners in the government and international agencies are asking how grass-roots village groups might be used as channels for loans (and as mechanisms for mobilizing local savings). So it is becoming increasingly important to find out what local options rural people have for borrowing and lending. At the same time it is worth reassessing the role of exogenous loans altogether, recognizing what is obvious but often overlooked: that credit also means debt. Credit is far from the only solution to African rural poverty. At least as often it is part of the problem.

After describing in brief some research methods used, the following section provides some definitions and basic principles. The third section of this chapter reviews some of farmers' local borrowing options, starting from the home outward. The fourth through sixth sections discuss comparatively new, institutional systems, suggesting how these tie into older, "informal" modes of finance discussed earlier. The seventh section surveys farmers' borrowing options commodity by commodity. The eighth section notes a few program approaches not recommended, and a concluding section offers some general and subjective remarks.

Sampling and methods. Borrowing and lending are sensitive topics in The Gambia. As other authors have commented, farmers are generally secretive about these transactions (Haswell 1975; Dusmore et al. 1976: 306n, 310n; cf. Tuck 1983: 111 on rural Senegal). This is so partly because of Islamic prohibitions on interest charges. The topic requires a combination of research methods. The study relies partly on structured surveys. We first interviewed 138 men and women in 1987, a man and a woman per sampled compound in five randomly selected villages in three divisions.[3] Figures in this study are based mainly on this survey. We revisited them with a similar but more detailed survey in 1988, adding other pairs in the same villages for a total of 167, each visited repeatedly.[4] We had stratified the sample universe of villages by these criteria: location east to west, bank of the river, presence or absence of irrigation, and ethnolinguistic composition.[5] In all but the largest village, 95 to 100 percent of the compounds were sampled by the second survey.

Together, the sample roughly approximated the nation's ethnic mixture: informants identified themselves as Mandinko (36 percent), Fula (or Peul) (28 percent), Wolof (21 percent), Jola (or Diola) (8 percent), Serahuli (or Soninke) (4 percent), and others (3 percent).[6] I chose and trained enumerator-interpreters who had worked in the sample villages already, who had kin there, or both, and who had earned villagers' confidence. I participated in many of the survey interviews. We resided in the villages (I lived in two of them, one Mandinka-speaking and one Fula-speaking, and visited the others) and interviewed farmers in their own homes.

Formal surveys are obviously not adequate in themselves for investigating a sensitive topic like this one. Other information came from open-ended and semistructured interviews, from indirect questioning and cross-zchecking, from local court records, and from personal observations. I took part in many activities of the villages where I resided and worked closely with several key informants. Additional interviews were conducted with various traders, cooperative officers, bankers, officers of government bodies, multinational agencies, and nongovernmental organizations.

A problem usually encountered in survey work on informal finance, in West Africa and elsewhere, is underreporting of transactions. The problem arises because some farmers feel ashamed that they have to borrow or afraid the government may disapprove of the channels they use. It also occurs because many women feel some cultural and religious pressures not to engage in major financial dealings outside their compounds. In longer questionnaire surveys, the problem can also arise because of impatience on the part of either informants or enumerators. In this study an attempt was made to keep interviews reasonably short by breaking the longer ones into two or more. While it was clear that some underreporting of loans occurred, informal conversations helped correct the information.

A related problem concerns interest charges. Lenders in Islamic African societies are seldom willing to tell about charging interest, though borrowers usually give more accurate information on this. Interview questions were pitched in such a way as to avoid specific mention of interest but to allow its calculation: informants were asked what and how much was borrowed, what and how much was returned, and when these transfers took place. Still, it was evident in cross-checks with borrowers that some lenders had underrepresented interest they charged, whether knowingly or not, and future researchers should be aware of the tendency.[7] Using a few key informants is important for overcoming problems like these.

In open-ended interviews, informants were asked not only about loans they had given or received themselves but also about loans of other rural people in their areas. This method provided a different picture and proved an equally useful way of learning about Gambian rural credit in general.

In sum, the survey results have had to be screened carefully in the light of knowledge gained in other ways. As always in research on African rural economies, much of the best information came from just talking with people.

Some Principles and Definitions

Rural Gambians borrow, lend, and save many more kinds of goods and services informally than they do formally. To understand rural borrowing and lending, then, requires a broad understanding of entrustment, encompassing not just money but also land, livestock, fertilizers, grain, machinery, jewelry, labor, and other goods and services. Credit may be defined as an exchange with delayed compensation and with or without interest. It need not involve an institution in the sense of a named organization.

Absence of institutional credit has often been assumed to constrain production in The Gambia, as elsewhere. It has been customary to consider credit something like a basic agricultural input, like sunlight or water, and to assume that poor farmers always need more of it. A more realistic view is needed. The flip side of credit is debt: the name depends only on whether one is the borrower or the lender and whether one is speaking before or after the loan. Development policies of international aid agencies and African governments since the Second World War have consistently favored credit and debt rather than domestic saving and storage, with results that appear not just to have impoverished borrowers and dulled their incentives to produce but to have endangered some of the lenders too.

But credit and debt cannot just be wished away. The Gambia's seasonal rain-fed grain agriculture (supplemented in some areas near the Gambia River by swamp rice and irrigated rice farming and by fishing and wage labor) produces an annual boom-and-bust economic cycle with which farmers can often cope only by borrowing in the "hungry season," which may stretch from May to September before the start of the harvest, which peaks between November and January. Development planners frequently express concern to increase "productive" and decrease "consumptive" lending. But these activities are frequently the same or so tightly interlocked (as in the case of reciprocal labor partially repaid in kind or livestock financing) that it makes little sense to try to distinguish them too sharply in institutional policies.

Plurality of decision-making units within the village. There is no single main decision-making unit in rural Gambian communities. Instead, decisions about different resources are made at different levels of family and community organization. The complex principles of social organization within Gambian villages cannot be discussed in detail here. In simplest

form, however, and in descending order of scale, the village, ward (or quarter), compound, work group, and cooking group are the residential units most commonly distinguished in the larger Gambian ethnic groups, and these usually have recognized heads.[8] But these groups may vary greatly in size and composition, and the categories may overlap, as where there is only one household in a compound (a pattern that appears increasingly common). Residential units within villages are usually structured around dominant kin groups, the patrilineal principle governing basic kin group membership and allegiance. Other principles by which villages are structured include age-sets and age-grades, hereditary castes, and many kinds of associations and clubs, some gender specific. These distinctions cross-cut each other in such a way as to produce many group and category loyalties for every individual. Economically, these translate into a variety of possible sources of credit or other assistance but also of competing claims on one's resources. Some of the village-level clubs and associations are being used as channels for institutional finance.

Roles of gender in financial markets. Rural Gambians tend to conceive of men's and women's property as constituting separate spheres. Resources lent to a husband may or may not reach the wife or wives. Some husbands relend borrowed resources, for instance cooperative inputs, to their wives at substantially higher interest (though some think the practice rare). Husbands and wives may or may not inform each other of how much they have borrowed or saved. Families thus should not be assumed a priori to be solidary economic units; nor, more basically, can they usually be understood as discretely bounded entities.

The role of Islam in structuring and reinforcing the Gambian income-stream partitions is considerable. Among the vast majority of Gambians who adhere at least nominally to the Islamic faith, there is a shared ideal that men should provide the main income from outside the household for family needs, while women should provide supplementary food for family use and other resources (monetary or nonmonetary) for their own personal use. Women are therefore discouraged from seeking income outside the compound or village but allowed exclusive rights over much of what property comes into their hands from farming or trade. These conventions are somewhat similar to those obtaining among non-Muslim Gambians. The overlay of Islam on local religions and customs has provided an additional code that men and women may variously invoke to suit their different purposes, though it often appears to favor male control of critical resources.

Women receive very little formal credit. Whether this is because their access to it is limited, as some have suggested (Elias Scharffenberger 1982: 11; FAO 1984: Appendix C, 103–4), or because they do not pursue it aggressively is a chicken-and-egg question: some appear to assume on the

basis of experience that it will be hard for them to obtain and do not pursue it for this reason. Institutional credit tends to reach them only indirectly.

For direct loans women normally turn to informal sources. Sometimes they find it helpful or necessary to borrow informally on their husbands' names in their absence. This can be a useful way for them to gain access to the husbands' earnings, as the creditor becomes an ally in the demand. There are risks, though, of misunderstandings and quarrels upon the husbands' return. Male shopkeepers report that they are often reluctant to lend to the wives of other men in the absence of those men, for fear they will be suspected of having illicit liaisons with the women. Perhaps because of these real and perceived discriminations, women have taken the lead in forming rotating savings and credit associations, as they have done in other parts of West Africa. Other kinds of village associations, too, are often more highly organized among women than among men, and some have been key organs of small-scale financial intermediation.

Indigenous savings in multiple forms. Gambians save in many ways sketched elsewhere (see Shipton 1990a and 1992), most of them nonmonetary. In the better times rural people convert easily volatile and divisible wealth into less contestable forms, particularly livestock (most important for men), gold earrings and other jewelry (most important for women), or household furnishings. They make these conversions partly to have their wealth in a useful or satisfying form and, just as important, to safeguard it from their spouses' or others' daily claims for spending. They keep grain in locked village grain stores and in domestic granaries. Many keep their money in locked trunks or small savings boxes they must break to open; others entrust cash to elder or more solvent villagers—I have called them unspecialized "money keepers"—to hold for them. A central concern is to be able to deny constant requests from kin or neighbors without appearing selfish. (This concern also underlies the success of indigenous group saving and loan associations.) In hard times those who have accumulated livestock or jewelry are forced to liquidate them to buy grain. Lending is also a way of saving, useful at times in keeping one's wealth inconspicuous and in unloading the risks of storage onto someone else. We look now at how lending occurs.

Local Borrowing and Lending

There is practically nothing in a Gambian village that cannot be borrowed and lent. The basic productive resources—land, labor, livestock, seeds, and tools—are all directly exchangeable for one another and for cash by countless ad hoc, individually tailored agreements, many of which take the form of short-term loans and counterloans. Food too, at the consumption end, is a medium of local lending and repayment.

Gambians turn to kin for loans of all kinds, some so subtle or so deeply embedded in other cultural meanings that to call them merely "loans" would seem reductionist. The framework of patrilineal kinship and virilocal postmarital residence, albeit negotiable and manipulable, provides most Gambian men with large sets of relatives within their neighborhoods and villages; and these patterns obtain in all the larger ethnic groups represented in the country.[9] The common pattern of marriage within villages or between neighboring villages creates, for a man or woman, lasting and enmeshed local bonds of obligation. Easier lending terms—usually flexible repayment schedules and no interest charges—make kin preferred sources of credit for labor, livestock, seeds, tools, and cash, though every rural Gambian knows that overlending among kin is likely to strain family relations more broadly.[10] It is a mixture of convenience, confidence, and often empathy that makes relatives likely lenders for many kinds of needs; but one need not rely on concepts like "affection," since a lender's decision is governed partly by expectations of return favors in a continuing social bond and partly by fears of malicious gossip if he or she refuses a favor asked without a good excuse.

The largest and longest-term loans in rural Gambian life involve kin, as do the smallest and briefest. Blood kin ties seem to be more frequently exploited for loans than marital ties: men or women may borrow from their parents, siblings, or cousins in preference to their own spouses or in-laws, though all these ties are used at times. As noted above, marriages in The Gambia often involve less free sharing of resources than marriages in some other parts of the world.

Nonetheless, some of a Gambian's most important debts in life involve marriage payments. As in most of Africa south of the Sahara, these are paid only gradually. Amounting sometimes to thousands of dalasis (D. 6 = U.S.$1) but varying greatly by ethnic group and class, they include cash payments from the bridegroom (and his natal kin) to the bride's natal family, sometimes rising to thousands of dalasis.[11] In addition to these transfers, grooms and their families are usually expected to provide cattle or other livestock for slaughter and other food in the weddings, and grooms to give their new wives such goods as beds, boxes of clothing, pots and pans, radios and tape recorders, watches, and sometimes animals and jewelry as they set up house. Yearly or more often until marriage debts are paid off, a bridegroom and sometimes his natal kin are expected to work for their in-laws. The great importance of marriage debts, financially, culturally, and emotionally, helps explain arrears and defaults in institutional credit. In-laws are likely to be considered the "creditors" with the strongest claim to a family's resources. This does not imply, however, that the government should try to regulate marriage payments. Most attempts to do so in Africa have totally failed and only caused public resentments.

Rural people throughout The Gambia depend for their livelihoods not just on farming but on urban and overseas labor migrations and the remittances that come back. To launch a young man's schooling or working career abroad, his parents, uncles, or other extended kin may pool thousands of dalasis. They must sometimes sell significant parts of their herds to do so, and they contribute on the understanding that he will send back money. In the villages visited, young men had traveled and worked in Spain, northern Europe, America, and elsewhere for varying amounts of time. Remittances were impossible to measure, but some had sent as much as 7,000 dalasis to their families at a time, and in some villages several of the largest houses with purchased materials had been financed this way. A young man with wage-earning potential represents for many farming families the main chance for advancement, and for many young men who travel to find work, debts to their sponsors may be the greatest they ever incur. It is not customary to send women abroad to find work, partly because of Islamic understandings (which may be invoked conversely to justify keeping them at home). Sending home money to a rural family frequently poses practical problems to labor migrants.

Livestock lending between and among villages is common practice, and it serves multiple purposes. It reduces a herd owner's exposure to risks of disease or theft, evens out labor needs and milk and manure supplies, distributes livestock to adequate and appropriate grazing, and helps large stockowners to keep their holdings inconspicuous to neighbors. In The Gambia as in other parts of Africa south of the Sahara, loans of draught animals among neighbors, sometimes in return for labor, help even out temporary economic inequalities while also forming a basis for patron-client ties that may endure beyond a season.

Unrelated friends and neighbors lend each other money or material goods on agreements that vary from the purely "helping" loan to the profitable business loan (*nfu* and *ndonto*, respectively, in Mandinka). Borrowers prefer to seek lenders from their own ethnic groups, on the assumption that the lending terms will be easier. In each of the largest Gambian ethnic groups, age grading and caste (hereditary occupational category, real or ideal) provide ties useful in local credit. Men lend to both men and women; and women, though they lend less than men, will also lend to either sex. There seem, however, to be preferences for borrowing from members of one's own sex.

Friends and neighbors in the rural villages do not normally demand collaterals or securities; they rely on their networks of acquaintances and relatives to help ensure repayment of their loans. Cash loans between unrelated people in villages seldom amount to more than a few hundred dalasis; many find it easier to recover loans issued in less volatile forms, unless they have a vital shop or other way of securing continued contact.

These mechanisms should not be considered "collateral substitutes," in an economist's conventional phrase, as though they were somehow second best. Instead, collateral is a confidence substitute.

Lending involving migrant farm labor: "strange farmer" share contracts. "Strange farmer" contracts (as they are locally known to anglophones) occur throughout The Gambia and in several neighboring countries. Gambian variants have been described as a kind of ground rent paid in labor: "in essence, the 'stranger' (in Mandinka, *samalaa*, plural *samalaalu*) lives with his 'host' and provides specified amounts of work in exchange for an exclusive use of a piece of land" (Robertson 1987: 205). Most strange farmers concentrate on groundnut growing, both for themselves and for their hosts. The host families give them food and lodging during the growing season. Seed, other inputs, and the crops harvested may be shared or lent between the host and strange farmer, depending on their particular arrangement, but the exchange of land for labor, often perceived as the scarcest resource in Gambian agriculture, is the central concern. Some 76 percent of strange farmers in The Gambia have recently come from outside the country, but some of the others may come from the very districts where they work (Swindell 1981: 40; Robertson 1987: 234). They are men, usually in their twenties and thirties, who generally come for the growing season only, but many develop relationships with particular hosts such that they return to the same places for several years.

The arrangements that strange farmers may make with their hosts are too varied to be described here, but the flexibility of these arrangements to suit the needs of both parties is one of their great advantages and a main reason why the institution of the strange farmer has lasted well over a century.[12] By one estimate, strange farmers produced about 32 percent of the groundnut crop in the early 1970s (Swindell 1981: 33; Robertson 1987: 219).

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

Village lending for profit. While there are few or no specialized rural moneylenders in The Gambia, shopkeepers, other merchants, and wealthy unrelated farmers are all important sources of loans for less solvent rural people.[13] Their loans may range in duration from a few hours to over a year, though loans this long are uncommon. Most important are their seasonal loans of foods they sell (rice, coarse grains, and sugar, among many other things) and of seeds, particularly groundnut seeds. These loans all increase in volume and frequency after seasons of poor harvests. They are normally repaid, in cash or kind, upon the groundnut harvest, which peaks in December and January.

Most shopkeepers and local merchants in The Gambia are members of local majority ethnic groups. Serahuli and Fula have gained reputations for small-scale trade around rural areas of the country. Also important are the country's dispersed population of Arabic-speaking immigrant Mauritanian shopkeepers, mostly men who robe themselves distinctively in pale blue and who do not intermarry with Gambians. Like many other rural merchants, Mauritanians are often locally stereotyped and resented for pressing stiff lending terms, as well as for setting what Gambians consider high sale prices. Altogether, the relations between Mauritanian rural merchants and their indigenous neighbors and customers in The Gambia are double edged, each side depending on but resenting the other. Recently urban and rural Gambians have threatened to chase some from the country temporarily with violence, as has also happened in Senegal. But Mauritanians in their arid home country rely heavily on their migrant men in The Gambia and other West African countries.[14]

Town merchant lending to groundnut farmers and rural entrepreneurs. The groundnut trade in The Gambia involves substantial amounts of credit for farmers, and control of the rights to market and lend for groundnuts is a major political issue. Private traders (including the licensed "agents" and their subagents, who relend to and buy from farmers on their behalf, and "buyers," who deal directly with farmers) compete with cooperatives. In recent decades the private traders have been losing, as the cooperatives set up as many as eighty-six rural *seccos* (buying stations) by the late 1980s.[15] The Groundnut Produce Marketing Board (GPMB) reported that the private traders' share of declared groundnut tonnage purchased fell from 84 percent in 1962–63 to 57 percent in 1971–72 (GPMB Annual Report, 1971–72), and again from 61 percent in 1975–76 to 19 percent in 1985–86.[16] Between 1964–65 and 1986–87 the number of private licensed buying agents dropped from seven to only two. (In 1981–82, sixteen smaller-scale licensed buyers were appointed, but many of these have since stopped trading.)

These changes are largely attributable to government allowance and loan discounting policies favoring the Gambia Co-operative Union (GCU):

measures the government and international agencies have sought to rectify.[17] It has become easier for some farmers who borrow from the traders to sell their groundnuts to the GCU and thus default on their loans. This has not been a clear-cut change, however, since Gambian farmers have always had opportunities to sell their groundnuts informally in Senegal. Apparently little credit occurs in the lively cross-border groundnut trade.

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

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

Village or town lenders appear to give more generous terms to wealthier borrowers and those who have salable property (livestock, machinery) than to poorer borrowers or those who do not, as others have also observed (Haswell 1975: 186; Dunsmore et al. 1976: 310).

Small business credit available to farmers. Merchants lend to other merchants. Among Gambians, immigrant Mauritanians, and others, it is by loans from relatives or friends in similar businesses and from private savings that most small enterprises get started. Business launching loans, like farm loans, often follow ethnic ties. Mauritanians, for instance, appear most commonly to borrow from other Mauritanians. Many of the smallest-scale Gambian business people finance their recurrent operating costs through very short-term loans from larger merchants. Women frying foods for sale in local towns or marketplaces, for instance, receive sugar daily on credit from small shopkeepers.

On a larger scale, wholesalers and retailers in the provincial towns also buy merchandise on credit (commonly rice and sugar) from large Banjul wholesalers, sometimes indirectly through the latters' rural selling agents. These loans are usually made on the basis of long-term acquaintance and customer loyalty, if not also kinship; trust is essential. Such businesses are highly competitive and retail markups limited to a few percentage points.

The rates of interest that urban wholesalers demand from provincial traders are correspondingly low: often about 5–10 percent over six months or 10–20 percent per year.[18]

Most Gambian small businesses are set up without institutional help, formal credit touching only a very small fraction. Private voluntary organizations, however, are now entering this field. The main government organ assisting small businesses is the Indigenous Business Advisory Service (IBAS), of the Ministry of Economic Planning and Development. Its activities have been confined mainly to the cities and large towns, and it had served no one in the sample studied.[19]

Social principles by which borrowers and lenders choose each other. Several principles have appeared as crucial substructures of rural lending: kinship, neighborhood and friendship, gender, caste, class, and trading partnerships of long duration. (In religiously plural societies religious links also play a major role; and in towns and cities common rural places of origin and school ties are also important links.) A person seeking an institutional loan may lack special links with the prospective lender. This is where reciprocity and political patronage become most important. Many foreigners summarily dismiss as nepotism the extension of kinship—usually extended family—into places where they do not want it. They label "bribery" or "corruption" a system that is really an extension of the free market into offices where it is not expected. A tip, payoff, bribe, or kickback is a kind of substitute for kinship or friendship. It may variously allow special privilege to those rich enough to pay it at the outset (and it certainly can enrich the recipient and his or her dependent kin); but, like kinship, it may also give access to credit to people too poor and powerless to get it by legal means (see Shipton 1985: 122–29). Much more research is needed to find out what kinds of people really gain or lose by these dealings.

Interest charges in informal credit. Interest charges are a rather secret topic in The Gambia, as noted earlier, because of Islamic prohibitions on usury, but there are ways of learning about them by subtle and indirect conversation.[20] Gambian merchants and other rural lenders commonly charge interest of 50–150 percent over six to eight months, but rates sometimes fall outside even this wide range (see Dunsmore et al. 1976: 310; Haswell 1975: 186; Shipton 1991). It is easy to conclude that the rates are usurious, but in fairness to lenders several factors must be taken into account, including inflation, the risk of default, the expenses of pursuing borrowers in arrears, and missed opportunities of using the capital in other profitable ways. As important as any reason for high rates is that most rural loans are made in the scarce season between May and August, when food prices are high, and repaid upon harvests, from December to February, when food prices are low. The resources are *worth* more when borrowed than when repaid. Farmers' reports also suggest that if all other things are

equal, loans issued in cash are usually more expensive than loans issued in other commodities.

Interest and Islamic sacred law. Islam, at least nominally the religion of the vast majority of Gambians, strongly conditions borrowing and lending customs and the ways rural people think about credit and debt, and it does so in ways many foreign financiers do not understand. Qur'anic prohibitions on usury, which many Muslims interpret to mean all interest charges, are pitched not in terms of *rates* of interest per unit of time but in terms of *ratios* of interest to principal (see Shipton 1991). To simplify a common Gambian interpretation, no matter how much time elapses, a lender must not "double" in lending:

> O Ye who Believe! Devour not usury, doubling and quadrupling [the sum lent] . . . and ward off from [yourself] the Fire prepared for disbelievers. (Part IV, Sura III, "The Family of 'Imran,'" Verse 130.)

Even if a low rate of interest is charged per month or year, it can eventually add up to an amount that will certainly be considered usurious in relation to the amount lent. Loan profiteering (Ar. *riba*, literally excess or unjustified gain) is one of the worst sins to Islam (though trade profits are allowed), and the Qur'an repeatedly promises damnation to usurers.

For this and other reasons, the duration of loans is usually kept as short as possible, for the lender's sake if not also for the borrower's. Interest-bearing local loans of cash, food, or other consumer goods may be made for hours, days, weeks, or (as with farm inputs) months but very rarely for more than a year. Loans are kept small enough to be repayable in short spans. And loan forgiveness is expected after accrued interest rises to a certain level. Gambian lenders have many ways (Ar. *hiyal*, legal devices) of obfuscating interest charges: for instance, switching commodities between loans and repayment or reclassifying them semantically as service charges, profit sharings, and so on. But interest is still believed fundamentally evil.

To fit in with local practice, institutional lenders in The Gambia should not assume that the same interest rates acceptable in short-term loans will also be acceptable in longer-term loans. They should not simply record, generalize about, or set interest rates without considering both the forms in which loans are issued and the forms in which they are collected. Nor should they expect to be able to let interest debts accrue indefinitely, even at rates they consider low. Rural Gambians may consider bankers or other financiers who break these rules to be even more alien and threatening than they consider trader-moneylenders from other Muslim countries who charge at "high rates" but often play by rules locally accepted or at least understood.

What interest rural Gambians charge each other, if any, depends on who they are and how they are connected, what is being lent, and when, among other circumstances. Loan agreements are made to measure, and there is

no one "conventional" interest formula. Indeed, whether interest is calculated by rates or ratios depends entirely on context and sometimes on negotiation.

Local mechanisms combining saving and credit. Most Gambian villages have associations within them that lend their members or other villagers labor, cash, or other resources. Most important are those called *kafo* (or *kafoo*) in Mandinka, most commonly and strongly organized among women. Virtually every Gambian village has one or more women's *kafo* groups, with leaders and sometimes other officers. Notable too, mainly among women again, is the local rotating savings and credit association (ROSCA) (*osusu* or *esusu* in Mandinka, *tontine* in French). These appear most notably in cities and market towns, but the practice has lately been spreading into small villages as well. *Kafo* and *osusu* groups are described more fully elsewhere (Shipton 1990a and 1992). They all rely on voluntary and relatively homogeneous membership (usually in gender, age, or class), links between credit and savings, and peer group pressures that guarantee repayment.[21] These last are effective because of multistranded social ties that give members easy ways of sanctioning one another.

The groups tend to be fairly simple in their financial operations, with contributions at regular intervals. Because loans come from members' savings, they are usually not larger than members can repay: another lesson for institutional lenders. Some institutional financiers envy these groups their apparent success in generating enthusiasm and repayments and seek ways to plug into them as credit conduits. A more sensible approach, in my view, is probably to leave them alone but to emulate the principles that make them work.

Having surveyed several kinds of "informal" finance operating within and between Gambian villages, we turn now to the ostensibly formal kinds of credit and debt, in which the government and international financial institutions participate. By now it is clear that rural Gambians have many kinds of financial obligations apart from institutional loans. Official lenders, far from being the sole claimants on their resources once loans are made, must queue up among other creditors who often take precedence in farmers' minds.

Institutional Finance: The Cooperatives

Begun under British colonial authority in 1955 and placed under the umbrella of a national union in 1959, the government-controlled cooperatives have grown to assume a very major role in The Gambia's rural lending, as well as in marketing.[22] With a total membership (active and

inactive) of about 110,000, the Gambian cooperatives have one of the highest rates of participation, in relation to population, of all government cooperatives in Africa.[23] Often several members of a residential compound belong. The Gambia Co-operative Union and its constituent primary societies have become the largest lender of groundnut seeds in the country and the only channel available to farmers for obtaining fertilizers, which they both lend and sell for cash.[24] They have also lent money and farm implements like ploughs, tine hoes, and donkey carts. In 1987–88 the cooperatives charged 24–26 percent nominal annual interest for seasonal credit, with a penalty for arrears.[25] Almost every farmer knows that the cooperatives charge interest, and many can estimate it, but few know the official rate or have had access to the kind of schooling that would enable them to calculate it precisely.

While providing services at prices that farmers cannot easily find elsewhere, the Gambian cooperatives have been associated with the same problems as many other government agricultural cooperatives across the continent. These include high expenses to the government, tardy input deliveries, sometimes slow payments to farmers, transport and storage bottlenecks, low and falling repayment, lax accounting, and theft (Ramamurthy 1986, Clark 1987).

Farmers' relations with cooperatives are ambivalent. They feel they have grown reliant on the cooperatives and value the goods and services provided, but at the same time many mistrust these bodies and feel alienated from them. What some credit analysts in The Gambia have called a decline in "credit morality" of borrowers is a result of this distancing. To many farmers the issue is not one of morality, since the cooperatives are an arm of the government and are likely to be represented by strangers. Farmers in The Gambia tend to feel much stronger "moral" obligations to real kith and kin than to these impersonal institutions, even though the cooperative loans have been subsidized.[26] When discussing loan repayments, farmers frequently commented that it causes great shame in their communities to be seen as pursued by government authorities for repayments. They worry that such visits might, among other things, hurt their informal "credit rating" with other villagers.

In recent years a problem for farmers in dealing with the cooperatives has been the Gambia Co-operative Union's jerking shifts in lending policies, problems attributable in part to changing requirements by funding agencies and other outside organizations and to national political pressures. Some years the cooperatives have issued cash for land preparation or food without lending seed nuts, other years seed nuts but no cash; fertilizers and tools have also been lent in some years but not others (see Clark 1987: Table 2). This has made it difficult for farmers to factor cooperative inputs into their planning. Debts have been forgiven in some

years but not in others; so some farmers who have repaid their loans on time have later felt cheated. More consistency and predictability are needed.

The cooperative as an anomalous unit and practical implications. A central problem is that the cooperative societies are not based on any locally recognized social, political, or economic units. Their domains are smaller than the district (in 1988 there were some eighty-six in thirty-five districts, making an average of 2.5 per district) but larger than the village (there are some 1,300 villages in The Gambia, thus an average of fifteen villages per cooperative society). Districts themselves are recent inventions dating from the colonial period; villages are the largest traditional social units effective now in The Gambia.[27] So the primary cooperative societies are a political anomaly.

It is clear from the findings presented herein and elsewhere (Shipton 1990a, 1991) that the informal credit systems that work in The Gambia are based on preexisting social relations. Most of the lending occurs at very local levels: within villages and often between neighboring compounds within villages; or, where occurring over distance, between close kin or long-term trading partners. The cooperatives could improve their repayment rates by making farmers' repayments consonant with their obligations to relatives, neighbors, and friends. This means using smaller groups than the present primary societies (average membership 1,279) as the elementary units of collective responsibility.

The cooperatives have made moves toward giving villages more responsibility for repayment.[28] For the system to succeed, this is probably a step in the right direction. The village is a natural unit to choose, for several reasons. It is spatially compact, it is socially and economically intimate, and it has its own political hierarchy. It is ethnically integrated: even where its members are of mixed groups, these will usually be groups that can get along. Its members have countless involvements with and obligations toward one another. Not all relations within villages are friendly, of course, but there is no unit larger than the village with such solidarity.

The village need not be the smallest unit of joint responsibility. Larger villages are subdivided into wards (in Mandinka, *kabilo* groups), each usually organized around a core lineage group (see Dunsmore et al. 1976: 269), and these too would seem a sensible choice in some ways.

Administratively, dividing village or ward groups into separate men's and women's groups for responsibility toward the cooperatives might be another possible measure, if an equitable system of allocation and recovery could be worked out. This would reflect the separation of men's and women's financial affairs that Gambian farmers tend to consider natural. The division might also add possibilities of female representation in the

cooperative committees and allow a better accounting of the resources being allocated to men and women.

Current efforts to decentralize decision making in the cooperatives should be watched for signs of success, including the cooperatives' use of villages as units of collective responsibility for repayment, in a pilot scheme of five villages. Both these moves make the cooperative organization more consistent with customary modes of political and economic organization and are steps in the right direction.

Links between cooperative and informal credit. The links between cooperative and informal credit systems are too many and complex for full treatment here, but these systems have become tightly intertwined. At local levels the connections can be variously collaborative, charitable, or exploitative. A basic point is that farmers frequently relend, sell, or give away resources they borrow from the cooperatives.

First they pass the resources to their families. Only a tiny fraction of cooperative members (probably about 1–2 percent) are women; so women's access to the loans is almost entirely indirect. Husbands relend to their wives. Usually, it seems, they try to pass on the exact interest charges levied by the cooperatives, but some add their own. In the villages visited a few were found to charge their wives as much as 50 percent interest over six months on loans of seed nuts they had received from the cooperatives, while paying the cooperatives 13 percent interest over the same period. Farmers relend cooperative seed nuts to unrelated neighbors or strange farmers at higher rates: some admitted charging 100 percent over about six months. Though cooperative society members can and do profit by relending, they accept some risks in doing so, as they may have to repay or lose their borrowing rights when their own borrowers default. Relending spreads the resources of cooperatives to persons that the official lenders may consider uncredit-worthy.

Sometimes several villagers group together to gain access to cooperative loans, helping one cooperative member among them to repay just enough of his outstanding debts to qualify for a loan in which they all might share. This strategy is sometimes used for procuring expensive implements from the cooperatives.

When inputs from cooperatives arrive late, as they often have, farmers nonetheless accept them, and they often sell or relend them. Farmers who have applied for loans may engage others to do their land preparation for them, on the promise of paying them when their loans finally arrive.

In sum, the functioning of the cooperatives cannot be understood without taking into account a wide variety of unofficial activities connected to them. Farmers have woven the cooperatives into their own older and broader systems of borrowing and lending. The cooperatives have taken over fertilizer distribution and, to a large extent, groundnut seed

distribution. Farmers now depend on them for these things, but the cooperative system in turn depends on farmers' private arrangements among themselves.

Institutional Finance: Private Voluntary Organizations

Several European and American-based private aid agencies (often called private voluntary organizations, PVOs, or nongovernmental organizations, NGOs) have experimented with small-scale credit or savings in The Gambia. They include Action Aid, Save the Children (United States), the Freedom from Hunger Campaign, and Catholic Relief Services. Several of their rural projects appear to be raising incomes in areas covered, for instance market garden projects, a sesame production and processing project, and schemes promoting small enterprises (beekeeping, blacksmithing, soap making, and so on). Other international organizations providing grants, and deserving more attention than they can be given here, include a number of Muslim charitable organizations headquartered in Saudi Arabia and other Arab countries. These have actively assisted well and mosque construction and funded Qur'anic studies abroad and pilgrimages to Mecca, among other things locally valued.

Not all rural Gambians distinguish PVOs from the government. To the extent that these are distinguished, however, the private agencies appear to enjoy a degree of public appreciation, respect, and trust in the rural areas that government financial institutions, notably the cooperatives, do not now share. Rightly or wrongly, their officers are perceived as being more honest, dedicated, and sensitive to local needs. Valued nonfinancial services like education and medical assistance have added to the good will.

The case of Action Aid. The case of Action Aid, a London-based private agency, illustrates the general shift in recent years from grants toward credit among "northern" private agencies operating in The Gambia and neighboring countries.[29] Action Aid undertakes agricultural assistance as one of several rural programs in The Gambia. Before 1982 it issued all farm materials in the country free. That year it shifted to a policy of 50 percent grant, 50 percent credit, the credit to be repaid over four years. In 1985 it cut the grants and began issuing all farm materials on credit, at nominal market cost but interest free.[30] The credit is issued on a revolving basis. As of February 1987 Action Aid had issued some 380,000 dalasis in loans, ranging in size from about 150 dalasis (short-term seed loans) to 2,000 dalasis (barbed wire loans), in about 120 villages. It had recovered about 80 percent of loans due that had been issued since 1984. (In beekeeping rates had been higher: 95–98 percent from 1983 to 1986.) The organization had recently started to experiment with loans of about 45,000 dalasis for grinding mills. Though lending was still subsidized, Action Aid's country

managers believed the organization to be moving toward a system of charges reflecting real costs. The organization is also now seeking ways to incorporate a savings component in its credit.

Action Aid lends exclusively through village groups (principally, in this case, women's *kafo* groups and "young farmers" clubs). Average membership in the groups is about sixty-eight. As this is considered for some purposes a rather unwieldy number, Action Aid has divided the larger groups into cells (called *kabib* or *kunda* groups) of about ten members. Like some of the other private agencies in The Gambia, it works countrywide: Action Aid works with about 175 rural groups in 130 villages, in four divisions.

Of Action Aid's income-generating projects involving credit, the most noteworthy is probably its dry-season market gardens for women in Kiang West District. By January 1987 it had helped establish twenty-five group gardens. Before Action Aid assists a women's group, the group must organize itself with officers and membership subscriptions and arrange with a youth group to cut dead trees for fencing posts. Action Aid provides groups with barbed wire on a three-year loan and seeds either on shorter-term credit or for cash at cost price. (The largest loans, for fencing, have been of about 2,000 dalasis per group.) Action Aid directs the digging of a well, drawing some of the labor and materials from the village. Though the garden as a whole is communally owned and managed, the garden beds within it are individually held and worked.

A 1984 Action Aid evaluation in Kiang villages found vegetable yields worth about 850 dalasis per group member. The main problem becoming evident was marketing. About two-thirds of the 1984 crop was reportedly consumed and one-third sold. Eighty percent of the produce at the time was onions, a crop not valuable for food when it cannot be profitably sold. Action Aid has responded to a lack of local market demand by diversifying the crops (into shorter- and longer-maturing onion varieties, cabbages, and hot peppers), by providing very short-term marketing credit to groups for selling group crops in larger towns, and by constructing onion storehouses. How serious the problems of market saturation will become remains to be seen. For the present, however, market garden projects like this one are very popular in the countryside, and villages without them are clamoring for them.

The Action Aid case suggests that private agencies can fill unoccupied niches in lending, not just by choices of activities but in their timing in a seasonal cycle with enormous fluctuations in the availability of labor and capital. The sensitivity to local group activity and the attempt to incorporate *kafo* and similar groups into institutional finance are promising signs. A remaining challenge is to incorporate saving with credit, as the most successful local financial organizations, like rotating savings and credit associations, do.

Problems for private agencies. A problem for private agencies in The Gambia is coordination among themselves, as organizations competing for recognition both in the countryside and in the capital. In many villages two or more agencies operate, lending or giving away resources on different terms, while other parts of the country go unreached. European- and American-based private agencies and international Muslim organizations might find more ways to assist each other, particularly in view of their linguistic capabilities in English and French, on the one hand, and Arabic (important as a written language and a minority trader language) on the other. Coordination might be provided by larger international agencies.

Unfortunately, a history of free handouts by private as well as public agencies has posed problems for private agencies that have recently entered the credit arena: many of their clients expect continuing grants.[31] A toughening of lending terms seems likely to be better received in the case of private agencies than in the case of agencies less trusted. But private agencies are not geared to become banks. They have trouble, in The Gambia as elsewhere, retaining their trained indigenous managers in the face of opportunities these individuals have elsewhere for higher salaries and promotions. The more a private agency moves into financial services requiring careful cash management and accounting, the more critical the issue becomes.[32]

Though private agencies are establishing a relatively good record of service in The Gambia, as elsewhere, and are therefore likely to attract attention from larger donors, it would be dangerous for them to become financially dependent on these. In the short run sudden and large infusions of donor money may isolate private agencies from the public they serve by excessively elevating the living standards of their field staffs. In the long run such money can jeopardize the organizations by making them dependent on fewer sources.

Disappointments and Experiments with Commercial Banks

Few rural Gambians have any direct dealings with the country's commercial banks, which have only two up-river locations, in Farafeni and Basse, and therefore may take the better part of a day's road journey, with its expenses, to visit. Fewer than 3 percent of the farmers we interviewed in 1987 reported having deposits in rural banks—and checks with the bank branches suggested the real figure may have been smaller (see Shipton 1990a). Still fewer, and practically no women, had or felt they had access to bank loans.

Farmers find the banks distant, mysterious in their operations, and not necessarily trustworthy. An experiment with mobile banking in the early 1980s, by The Gambia's Agricultural Development Bank, led to bitter and

lasting disappointments when it collapsed, the vehicles rolling away for the last time without returning rural people's deposits. Still, in interviews, farmers strongly supported the idea of mobile banking, and they wished it tried, or tried again, in their neighborhoods. They also strongly supported the idea of establishing small branch banks in rural settings, for savings if not also for credit.

A novel and bold approach to grass-roots rural finance has been taken by the French-founded Village Banks Project in the Jahally-Pachar area. Its strategy involves several key features: (1) a cautious pilot project, starting with only a few villages, with generous lead time for local research and a public information campaign; (2) a survey of the area's village *kafo* groups undertaken by the organizers in the planning stages; (3) deliberate separation of the banks from the state; (4) separation of men's and women's funds; (5) linkage of savings and credit such that only depositors may borrow; (6) use of positive real interest rates in both savings and credit (the organizers planned about 25 percent for savings and 40 percent for loans); (7) limitation of external capital to be used; and (8) minimal use of expatriate staff.

It was planned that the project would limit savings to term deposits of three and six months, that the banks would open only once weekly, and that staff would be recruited from the villages they served if possible.[33] It was envisaged that the staffers would be people of some personal means by local standards, a policy consistent with the way locals select their informal money keepers. In short, this was a project designed with much sensitivity and a state-of-the-art approach. Its outcome was not yet apparent at the time of study, but projects like this one should be closely watched for lessons that might instruct other organizations.

Private agencies as potential links between banks and rural people. The private voluntary agencies in The Gambia have never been strongly linked with the commercial banks, but there may be ways of developing such links to the benefit of rural people and all other parties. Private agencies that lack (as most do) the capital or the specific managerial capacities to handle banking might best let the banks handle the money, finding instead a role instructing rural people about the pros and cons of institutional savings and credit, explaining interest policies, helping to prepare and process loan applications, and so on. The private agencies' public goodwill could help provide the links that banks need to earn trust in the countryside. Their members' knowledge of individual farmers, families, and villages could provide for the banks an important character-screening mechanism. The private agencies are also well placed to explain to banks what in their policies and practices is too difficult, risky, or morally compromising for farmers to accept. In short, private voluntary agencies are likely to be able to serve farmers best as informational, rather than

financial, channels between them and banks. The flows of information, like the flows of capital, should be two-way.

Summary of Lending Channels for Specific Agricultural Inputs

Money. Farmers obtain loans of money from many sources, though most of the sources lend only small amounts (Table 6.1). Relatives, neighbors, and friends are the most common sources, particularly for very small or very large amounts; shopkeepers and other traders also lend. Among the institutional lenders, the cooperatives are the major lending source for men in the rural areas. In the 1987 survey 68 percent of the men interviewed stated they had borrowed money in the previous twelve months. Of those who had borrowed amounts significant enough for them to mention, 57 percent had borrowed mainly or exclusively from the cooperatives. Of the remainder who had borrowed, 35 percent had borrowed from kin and 65 percent from nonkin. Of these same male informal borrowers, 35 percent had borrowed from merchants and 65

TABLE 6.1
Usual Sources of Credit to Farmers, Part I, Money (dalasis)

	0–99	100–499	500–999	1,000+
Relatives	X	X	U	U
Neighbors, friends	X	U	U	U
"Strange farmers"				
Hosts (for "strange farmers")				
Kafo groups (village organizations)	X	U		
Osusu groups (rotating credit associations)	X			
Alkalos (village headmen)	U			
Imams or marabouts				
Village merchants	X	U	U	
Town merchants (including groundnut traders)	U	U		
PVOs	E	E	E	E
GCU cooperatives	X	X		
Department of Agriculture				
IBAS	E	E	E	E
Commercial banks	U	U	U	U

NOTE: X = loans common; U = loans possible but uncommon; E = loans for supervised enterprises.

percent from farmers who were not merchants, including a district chief and a marabout.

Of the women interviewed, 10 percent said they had borrowed money in the previous twelve months. Of these, not one said she had borrowed directly from a cooperative society; all reported having borrowed from neighbors, friends, or relatives. Of these women borrowers, three had borrowed from kin and four from nonkin. Three of them had borrowed from merchants and four from farmers who were not merchants. Of these last four, one had borrowed from a *kafo* group. Probably more men and women had borrowed money informally than reported having done so. And, as noted earlier, more borrowing and lending occur after bad seasons than after good seasons like the one preceding the survey.

Amounts of money that farmers reported having borrowed from the cooperatives in the twelve months preceding the 1987 survey varied from 90 to 240 dalasis and averaged 119. Reported amounts borrowed from other sources informally varied more widely, from 15 to 1,000 dalasis, and doubtless others had borrowed amounts below 15 dalasis that they did not report. Whereas the cooperative loans were nearly all issued between June and August, informal loans occurred year-round. In both amount and timing, therefore, informal sources would seem to offer more flexibility than the cooperatives.

Land, labor, and livestock. Land, labor, and livestock are usually lent only informally (Table 6.2). Available sources include relatives, friends, neighbors, village headmen, *kafo* groups, and strange farmers or their hosts. Most of the mechanisms for lending and sharing these things are deeply embedded in local social organization and connected to political and ritual functions. Individuals, households, and compounds hold interlocking and overlapping rights in these resources, and these rights change in character seasonally. Access to these resources is thus not easily understood in conventional economic terms.

Implements. Farmers obtain hand tools like hoes from local blacksmiths, often on loans that take the form of customary gifts with the tacit expectation of a return in kind later, after a harvest (Table 6.3). This form of credit, however, is yielding to cash sales. Animal-drawn tools including ploughs, seeders, and mechanical hoes are very commonly lent between relatives and neighbors and from hosts to strange farmers for several days at a time, often as part of arrangements where other goods or services are provided in return. But borrowers usually have to wait until the owners are finished with them, and this often means planting or weeding late. For permanent procurement there are no significant informal channels for implement loans. The cooperatives have issued animal-drawn tools and carts on medium-term credit. PVOs have issued these in places as loans, grants, or both, and they are beginning to experiment with partial loans for

TABLE 6.2
Usual Sources of Credit to Farmers, Part II

	Land	Labor	Livestock
Relatives	X	X	X
Neighbors, friends	X	X	X
"Strange farmers"		X	
Hosts (for "strange farmers")	X		X
Kafo groups (village organizations)		X	
Osusu groups (rotating credit associations)			
Alkalos (village headmen)	X		
Imams or marabouts			
Village merchants			
Town merchants (including groundnut traders)			
PVOs			
GCU cooperatives			U
Department of Agriculture			
IBAS			
Commercial banks			

NOTE: X = loans common; U = loans possible but uncommon.

TABLE 6.3
Usual Sources of Credit to Farmers, Part III

	Fencing material	Tools (hand, animal)	Tools, power	Carts
Relatives	X	S	S	S
Neighbors, friends	X	S	U	S
Hosts (for "strange farmers")		S	U	U
Kafo groups (village organizations)	X		U	
Osusu groups (rotating credit associations)				
Local blacksmith		(hand)		
Alkalos (village headmen)		U		
Imams or marabouts		U		
Village merchants		U		
Town merchants (including groundnut traders)				
PVOs	X	X		
GCU cooperatives		U	U	X
Department of Agriculture			U	
IBAS				
Commercial banks				

NOTE: X = loans common; U = loans possible but uncommon; S = short-term loans (days or weeks) only.

heavy machinery like oilseed crushers. But neither the cooperatives nor the PVOs appear to be satisfying farmers' demands for animal-drawn or power-driven farm machinery.

Groundnut seeds. Groundnut seeds are available on loan from the cooperatives, relatives, neighbors, and occasionally traders (Table 6.4). The cooperatives have become by far the most important institutional source, normally lending amounts between 50 and 300 kilograms per borrowing farmer. By one recent estimate, of the 14,000 tons of undecorticated seed nuts required annually in The Gambia, 50 percent are saved in village seed stores and 14 percent on the farms, and 36 percent are provided by the cooperatives (Clark 1987: 32).[3,4] The survey for the present study found that 57 percent of the men interviewed had borrowed groundnut seeds from outside their compounds in the preceding twelve months and that 97 percent of these said they had borrowed mainly or exclusively from the

TABLE 6.4
Usual Sources of Credit to Farmers, Part IV

	Food	Groundnut seeds	Other seeds	Fertilizers	Pesticides
Relatives	X	X	X	a	
Neighbors, friends	X	X	X	a	
"Strange farmers"					
Hosts (for "strange farmers")		X	X		
Kafo groups (village organizations)	X	U	U		
Osusu groups (rotating credit associations)					
Alkalos (village headmen)	X	U			
Imams or marabouts	X				
Village merchants	X	U			
Town merchants (including groundnut traders)	X	U			
PVOs			V		
GCU cooperatives		X	U	X	
Department of Agriculture				C	X
IBAS					
Commercial banks					

NOTE: X = loans common; U = loans possible but uncommon; V = loans for vegetable inputs; C = loans for cotton.
a. Fertilizers obtained through relatives, neighbors, and friends nearly always originate from the GCU cooperatives.

cooperatives. Among the women, 7 percent said they had borrowed groundnut seeds from outside their compounds in the preceding twelve months. Of these (five women), only one said she had borrowed directly from a cooperative.

Again, it is likely that private borrowings were underreported in the survey and that private borrowing was lower in 1986 than in other years because the 1985–86 harvest had been a good one. But it is clear that the cooperatives are a most important source of groundnut seeds on loan, especially for men. Farmers count on being able to receive cooperative loans directly or indirectly. In the spring of 1987, before cooperative loans were due to be issued, many farm families began consuming their own stored seeds in the expectation that cooperative seed loans were forthcoming.

Much of the seed nut from the cooperatives is relent within villages and within families, sometimes at higher interest. Women rely heavily on informal and indirect access to seed nuts, as few belong to the cooperatives. Some men farmers who borrow from the cooperatives sell part of their seed to small-scale traders, who resell it locally by the cup as food. Delays in cooperative loans until after planting time make the seed nuts more likely to be used this way.

Strange farmers who borrow seeds usually rely on their hosts for these, commonly repaying double at harvest. According to the 1983–84 national Agricultural Survey, 43 percent used their own seed nuts, 37 percent borrowed, 17 percent bought, and 6 percent received them free from others (see Robertson 1987: 228). Farmers who lend land to others or labor for them may be compensated in seed upon the harvest, particularly if their own harvest has been poor.

Other seeds. Little formal borrowing and lending occur in seeds other than groundnuts. Relatives, friends, and neighbors are the usual sources of seed loans in the other crops. PVOs issue seeds for new crops (European vegetables and recently sesame), together with other assistance, on various bases including interest-free loans, grants, and mixtures of the two.

Fertilizers and other chemicals. Fertilizers are available to farmers almost exclusively from the cooperatives, the exception being the special projects of the Department of Agriculture or, very occasionally, those of other agencies.[35] About 42 percent of the men farmers in our 1987 survey said they had borrowed fertilizers from outside their compounds in the previous twelve months. Of these, 97 percent said they had borrowed mainly or exclusively from the cooperatives. Only one woman (1 percent) interviewed said she had borrowed fertilizer from outside her compound; no woman had borrowed directly from the cooperatives. (Probably more men and women had borrowed from relatives or neighbors than reported having done so.) Cooperative borrowers took amounts varying between

one and five 50-kilogram bags, but most borrowed three or fewer. Men farmers sometimes relend or sell fertilizers they have borrowed from the cooperatives but apparently not as often as they relend and sell borrowed groundnut seed. The market is more limited, since only well-off farmers can afford to buy fertilizer in the summer months when cash is scarce.

Pesticides are not normally available to farmers on loan. Spraying and dusting services have been available from the Crop Protection Service of the Department of Agriculture.

Some Approaches Not Recommended

Several organizations in The Gambia have invested considerable time and effort trying to encourage farmers to minimize ceremonies deemed "traditional" and "wasteful": naming ceremonies, circumcisions, weddings, and funerals. Such "modernization" campaigns achieve little or nothing, and they waste resources themselves. The ceremonies are misunderstood—development agencies usually pay little attention to their economic, political, sociocultural, or nutritional functions. More to the point, they are locally sacred events that are simply beyond agency or government control.

Development planners in The Gambia have occasionally raised the question whether the government should try to title rural lands as individual property to facilitate credit. Experience elsewhere in Africa south of the Sahara suggests that this would be a bad idea for The Gambia. It has nearly always proved a failure. An expensive and time-consuming process that may involve years and even decades of adjudications, it tends to lower rather than raise security of tenure, to discriminate against women, elders, and children, to produce land registers that quickly become obsolete, and to give rise to double deals and confusion concerning land titles and mortgages. It may speed up the concentration of holdings into fewer hands and thus jeopardize political stability later. For all this, rural land registration usually improves access to credit only slightly. Land titles become a necessary but not a sufficient condition for loans as banks and public lenders continue to insist on salaries or other attachables.

Mortgage systems have proved unworkable where tried in rural Africa because of stiff local resistance to dispossessions (see Shipton 1985, 1988, 1989b). Land mortgage foreclosures, where tried, are deemed a most serious injustice involving more than just individuals or small families. In societies with lineages, such as are found in most of the densely settled rural areas of Africa, it is usually next to impossible for lending institutions to auction off farmland, because relatives of the dispossessed are likely to live all around. These relatives make life difficult for anyone who tries to take over the land, sometimes during the auction itself.

Some General Observations

Informal systems of saving and credit in The Gambia are pervasive, diverse, and fairly flexible, and they take many forms not usually noted in "financial sector" reviews. These include widespread lending of land, livestock, labor, tools, seeds, and money, informal rural (and urban) deposit taking, village men's and women's groups, rotating savings and credit associations of various kinds, religious exchanges, delayed marriage payments, family investment in labor migrations, reselling of hard household goods, and numerous other mechanisms. While many of these practices may not be construed as directly or immediately productive, they often do contribute indirectly to production and to kinds of consumption that make production possible. Farmers unassisted by governments, cooperatives, or banks are neither without credit (as some reports would have it) nor entirely at the mercy of moneylenders (as others would have it). The institutional systems based in Banjul are only a small though important part of the picture in the villages.

Resources of nearly all kinds are lent at local levels, and some are lent over long distances or between Gambian hosts and international migrants. Gambian farmers live in a credit economy already: most are perpetually involved in a complex web of debts and credits to relatives, neighbors, friends, and merchants. Officers of lending institutions should understand, then, that farmers have their own personal hierarchies of creditors and needy others and that the newest, most distant, and least familiar lenders rank at the bottom. This knowledge adds some perspective to foreign lenders' judgments about moral hazards and borrower delinquency.

Rural Gambians' own "informal" loans vary greatly in duration. Debts involved in marriage or in major livestock loans may sometimes last longer than a generation. Aside from family investments to send young migrants away for schooling or work, transactions that may or may not be classed as loans, nearly all the existing indigenous money lending is for periods shorter than a year. Much of it, in small-scale trade for instance, occurs on the basis of weeks, days, or even hours. Interest charges levied on longer-term loans are problematic not only for borrowers but also for lenders, because of religious proscriptions locally interpreted as forbidding high interest rates *or* ratios of interest to principal as finally paid. This may indicate a hazard to potential lenders or, seen another way, a gap to be filled. Agricultural credit for heavy machinery, fruit trees, and other purposes requiring several years for payback is virtually nonexistent. Such ventures should probably be attempted only by institutions already on a sound financial footing.

The high real interest rates on money loans in the rural areas and the embeddedness of most cash lending in social relations attest to the difficulty of lending money in The Gambia. Just as the members of a rotating contribution club know each other intimately and have many ways

to sanction one who fails to cooperate, any institution that enters the financial picture must know a certain amount about its borrowers or must find ways to rely on their mutual interactions and pressures among themselves to keep the system running. In The Gambia these local associations deal in amounts that outsiders find surprisingly small. This may serve as a warning, or at least a challenge, to institutions entering the picture, though it may also be taken as a sign of an unfulfilled need.

In arranging their own ad hoc loans of land for labor, tools for seeds and radios, and so on, farmers show that local credits and debts are flexible things, often repayable in forms other than those initially issued and often renegotiable. Money sometimes enters these agreements, sometimes not. "Finance" is not a discrete sector of life. As farmers see it, there is no reason why "formal" loans from cooperatives or international agencies should not be passed on to kin or neighbors as "informal" loans or gifts or why borrowed groundnut sacks should not be used for roof repair or bedding. Sectors like agriculture, housing, trade, or industry simply do not mean as much to rural people as they do to agency or government planners, whose perceptions are often structured or concretized by the corridor divisions of their offices.

The functions that government lenders have lately served—chiefly, providing groundnut inputs and tools and cash amounts over 100 dalasis for farming—are quite specialized within the broad context of rural financial processes in The Gambia. The government cooperatives have captured much of the groundnut seed and fertilizer markets, though borrowers distribute some of these inputs further by loans and sales between and within families. Farmers have grown reliant on the cooperatives to provide these things, but they do not find the cooperatives reliable enough. Similarly, the money lending of the cooperatives is appreciated, but farmers find it too sporadic. Cooperative cash loans are bigger than most "informal" seasonal cash loans, and it is hard for farmers to find such amounts elsewhere without paying steeper interest. These loans are used as mechanisms of political patronage and control, and cooperative loans engage farmers in local or national structures of authority and obligation. As everywhere, farmers know that there is a price, economic or otherwise, to borrowing. If they are not made to repay their loans in cash or groundnuts, they will be expected to repay them in votes or campaign cheers.

Credit will never improve farmers' livelihoods by itself. While it helps them survive a boom-and-bust seasonal cycle and to weather years of low harvests, it is as likely to addict and impoverish them in a vicious circle, as drinking seawater dehydrates a sailor, or to bond them to their lenders in ways they will eventually resent. Gambian farmers want to save as much as to borrow. Much remains to be learned from them and other West Africans about how to combine credit with local savings for rounder and fairer financial systems and about what kinds of finance they need in the first place.

163

Carlos Cuevas

Comment

It was certainly a pleasure to read a paper by an anthropologist. It was a pleasure after I overcame the anxiety of not finding tables with R-squares and supply-and-demand diagrams.

First, I want to identify several similarities between Professor Shipton's findings and the findings of studies from 1986 through 1988 in Guinea and Cameroon with which I have been involved. Then I shall focus on the paper's challenge to the applicability of conventional economic analysis to African informal financial markets.

The relative importance of informal to formal financial markets reported by Professor Shipton's paper corresponds very closely with other recent applied research in Africa. Guinea, for example, is an extreme case of near-zero access to formal institutional sources of financial services in credit and savings. Last year in a field survey comprising a sample of 250 households in two regions of Guinea, we found only one reported loan from a formal financial institution, and that entity was essentially a marketing cooperative. That is about the extent of formal credit in Guinea, insofar as we could measure it. In contrast, about 60 percent of the country's households had engaged in some kind of informal borrowing during the year preceding the survey.

The relative importance of different sources of informal borrowing were also very similar to those reported in Professor Shipton's paper. Relatives are by far the most important source, but traders and moneylenders are not negligible sources.

About one-third of Guinean households in our survey participated in informal savings groups. In Cameroon some reports put that proportion at two-thirds of the population participating in some kind of informal savings and credit groups. And, at the risk of extrapolation from the sample of a study we have just completed, credit granted through informal savings groups in Cameroon is equivalent to about two-thirds of the credit granted by the country's commercial banks.

So the importance of informal markets is very, very substantial, coinciding, again, with the assessment Professor Shipton presents to us. Savings held and mobilized by informal savings groups appear to be at least as important as deposits with commercial banks. Informal savings groups in Cameroon report practically no bad loans because the social sanctions are so strong that people will do virtually anything to pay their loans before defaulting on them. But informal loans outside such groups may suffer greater defaults, as indicated by this paper. Otherwise the quality of performance of informal financial markets is not very clear.

With respect to what Professor Shipton calls the challenge to conventional, Western economic analysis, I agree with most of the points he makes. Nonetheless, I shall play devil's advocate and try to defend the applicability of conventional economics for analyzing informal markets in Africa.

My first remark is that it is appropriate to talk about informal financial markets, in the plural. It seems to me that loans and assistance provided among people within one level do not belong to the same market as credit provided by shopkeepers or traders. They are connected but loosely so; I would put them in separate markets.

That brings to mind the fact that loans are heterogeneous commodities, characterized by several components that vary across different transactions. That is true not only in informal markets in The Gambia but also in more developed financial markets. A housing loan in the United States is very different from a car loan or a consumer loan. Terms are different. As long as we recognize this heterogeneity, we can move ahead and analyze loans using some conventional economic tools.

Lenders' behavior is another important issue addressed in the paper. As Professor Shipton puts it, credit is demand. Hence lenders have the upper hand (using his terminology) in establishing loan terms and conditions. Translated into the economists' jargon, lenders are price setters. Price-setting behavior is at the root of all recent literature on credit rationing in the United States and elsewhere. All the literature on credit rationing begins by assuming price-setting behavior on the part of lenders. This does not mean, however, that monopolistic power and market imperfection prevail wherever "credit is demand." It *does* indicate an open issue for research in the African context; market structure is seldom addressed in the literature.

Finally, as Professor Shipton indicates, there is a close similarity between Islamic rules regarding interest and the avoidance mechanism. Mechanisms to avoid Islamic prohibitions regarding interest are very similar to those avoidance mechanisms that we see applied by formal financial institutions in developed and non-Islamic countries, here and elsewhere.

In summary, it seems to me that there are several similarities between the picture drawn by Professor Shipton's paper and some better-known scenarios of more developed economies and more formal markets. Nonetheless, he is correct that their differences impede ready utilization of the basic tools of economics in the analysis and understanding of these markets. The challenge is in the adaption of these analytical tools and techniques to the peculiarities of African growth in financial markets. We need to recognize explicitly and specify in our models the traditional practices and the cultural constraints that are characteristic of these markets. I see more room for interdisciplinary research here than anywhere else.

The other major challenge is definition and measurement of some of the relevant variables we want to see in our analytical models. This is the crucial problem that is encountered every time we attempt applied research in Africa. Just the definition of what the economic unit is, is problematic. What is the household in the African context? It is not as simple to define as in the United States and other countries. Should we employ the economic unit formed by a couple and their immediate dependents or the extended family? And, if the latter, what are the criteria for specifying its limits? Depending on those, the extended family could have 15 members or 200.

Finally, the paper settles the issue of interest rates to my satisfaction and points toward other areas of the loan contract that need more attention. Among these I propose as the next major area of attention in future research collateral and collateral substitutes. What is the difference between the so-called land-abundant countries and those farther south? The other merit was the paper's distinction between savings mobilization, links, and networking as against institutional development of the kind set forth previously in this volume. Which should be the principal objective of reform? One answer is likely to yield different research than would ensue from the other. Thus that is one more open question that should be pursued.

Discussion

Melanie Tammen: How are these informal mutual savings efforts being affected, if at all, by the trend toward increasing producer prices in the Cameroon or elsewhere? Is the scale of these associations changing?

Parker Shipton: So little is known about the price responses in informal lending that very few generalizations can be made. While it would seem to follow that price rises would induce informal savings and credit groups to deal in bigger amounts, we still lack longitudinal studies that would let us say for sure. We do know that in rain-fed rural economies, as in The Gambia and other coastal West African countries, when cash becomes scarce in the "hungry" season, the local indigenous financial associations often stop operating temporarily until the next harvest.

Carlos Cuevas: An indirect answer to your question is provided in the Cameroon by the differences between women and men—in both the crops they concentrate in and their participation in informal savings groups. At one point the prices of cash crops, which are primarily men's business in Cameroon, were down whereas prices of vegetables and seasonal crops, which are primarily women's activity, were high. This appeared to account for the greater participation by women than by men in informal groups. This difference is at least consistent with a hypothesis that running a more profitable business increases activity in informal savings groups (putting more money in or participating in larger numbers).

There is a connection, someone said this morning, between the real sector and the financial sector, and this is a clear example of that connection, but it is revealed only because of a gender difference in the real sector.

Jerry Wolgin: I was wondering what your research suggests about the uses by rural inhabitants of the credit they receive. Particularly, how much of it is used for enhancing their capacity to increase income in the future?

Parker Shipton: On the surface most unofficial credit in The Gambia and elsewhere in rural Africa is for consumption rather than production. But this is a hard thing to measure. The line between productive and consumptive uses is unclear, and some of the uses that look like consumption on the surface turn out in some indirect way to be productive. If one cannot consume, one cannot produce. For instance, although in June, during the Gambian planting season (which is also the hungry season), the borrowed "ploughing money" that a farmer diverts, say, toward ceremonial feasting becomes a consumption loan, it still contributes indirectly to production because farmers need the energy for land preparation and weeding now. June is the start of the peak labor season, and without "subsistence" loans farmers may lack the food and the energy. Malarial mosquitoes are also breeding during the rainy season, and illness is draining energy further. One is also using the loan to maintain the social bonds that will help one later in production, for instance in reciprocal weeding. Farmers who "divert" institutional loans from crop inputs into livestock purchases—which is a pretty common pattern—are using them in investments and savings at the same time as "consumption." In the end it does not make sense to try to distinguish sharply between production credit and consumption credit.

J. O. Sanusi: A question asked in a prior session and left unanswered might be addressed now. The speaker specifically was asking about the quantification of the amount of bad debts that occur in the informal sector and also the interest rates charged in the informal sector as well as the rules that may have emerged regarding those rates.

The beauty of the informal sector is that it is informal. When we start thinking of the moneylender, setting up rules and formalities for the informal sector, we are taking it from the realm of informal to formal. The beauty of it is that everybody does it in a way that he considers beneficial to himself and gets a result, although over time there is a pattern.

The description of the informal sector of The Gambia that you give is not very different from that of Nigeria. Part of the reason why the informal sector grew is the lack of accessibility to the formal sector.

The types of regulations that we have in the formal sector occasionally, of course, also allow the informal sector to grow. For example, because of the political sensitivity of government, the level of real interest rates in most of the developing countries is low—in many cases negative—and the banks are even more reluctant to take risks than they would otherwise be.

In contrast, the informal sector is free to charge whatever rate of interest it wishes, to compensate for the level of risk it considers acceptable. In Nigeria the only limit on the interest rate that a moneylender can charge is whatever a borrower is prepared to accept. This allows the moneylender to take risks that would be imprudent for a bank officer to assume. The informal sector is able to take risks that are not available to the formal sector because it is able to charge borrowers for doing so. Even when it sustains a loss, there will be enough repaid loans to cover the loss and still make some profit at the end of the day.

Over time we have tried to reduce the activity of the informal sector in Nigeria by making it compulsory for some of the commercial banks to go to the rural areas where they would not be likely to go because by their own evaluation they could not make a profit there. It has been discovered that those evaluations are sometimes wrong. Once they are in certain areas, they discover that they are able to make profits because they generate a lot of deposits; having access to these rural banks, the rural people no longer keep their money under their pillows or bury it in the ground or keep it in boxes. They take it to the bank where they can get some interest.

Because of the closeness of the rural bank managers to the rural people, they know them as much as the informal lender knows them. Because of that they can take a risk on them. Nonetheless, this does not mean that the informal lender is out of business, because there will always be risks that no formal banker is prepared to take.

Parker Shipton: The experience you cite in Nigeria parallels others in Indonesia, where rural people with new access to branch banks have lately proved surprisingly eager to save in them. Both these seemingly successful cases contrast with this morning's case on Guinea, where small branch banks were staffed with expensive expatriates who did not know the backgrounds and antecedents of their customers. The local knowledge seems to be one reason why the projects worked.

In The Gambia, too, much could be done to make commercial banks seem less remote and intimidating to rural people. One approach would be to find new ways of linking commercial banks with private voluntary organizations. What the commercial banks have to offer, comparatively speaking, is their expertise in money management. What the PVOs have to offer is local goodwill and grass-roots contacts. There is much room for experimentation with PVOs or nongovernmental organizations (NGOs) *not* as financial intermediaries—because they are not equipped for banking and they cannot afford to hire or keep good bankers on their staffs—but as information channels. They should help the flow in two ways. They could usefully intervene in explaining the pros and cons of banking and bank procedures to potential savers. From the banks' perspective they could be useful in the process of screening loan applicants and contacting bad debtors.

Carlos Cuevas: That approximates what I meant by networking, although I had in mind, specifically, what is observed in northern Cameroon. There are informal groups participating in what I call quasi-informal organizations that hold the profits of the informals' central liquidity funds, eventually depositing these funds with formal banks. Instead of direct deposits with a bank that has branched into their particular area of residence, as Mr. Sanusi indicated is occurring in Nigeria, the community in remote rural areas is doing its own branching through intermediary organizations in the direction of formal deposits.

The problem that remains is that the branching process does not work much in the other direction. Banks will take an informal savings group as depositors at any time, but it is very, very unlikely that they will lend to them at some point. That remains an issue that needs to be addressed.

A. B. Ndofor: I want to offer a comment on the question of how much of the credit goes for production rather than consumption. My experience is that this is a very difficult aspect to judge because the question of fungibility is quite applicable, especially in the rural areas and in the informal sector. But the only way to see whether the loans actually go for production is by taking the borrower's net worth at one point in time and his net worth maybe twelve months or twenty-four months after and seeing whether he has made progress in his total holdings.

Especially in the rural areas, there is no distinction between investment money and consumption money. It depends on which comes first—the need to invest or the need to consume. Again, we have to distinguish a little bit, especially in Africa, what we call consumption since there are not so many cars in the rural areas, or televisions, refrigerators, and so on. Very few people take car loans or loans for other durable goods. When they do take a car loan, they are taking it for a taxi or probably to haul produce. At the time they do not distinguish that car from their own personal car. Many if not most businesses are so linked to the individual proprietor that personal assets are hardly distinguished from business assets.

At the same time, during a school season a man in the rural areas who has just received money for his produce may use that money to pay for the education of his son or daughter. If, later on, he has to borrow money to put into his agricultural production or his business, the loan would be deemed as being for production. But suppose the reverse sequence had transpired, and he had to borrow for schooling—would he be said to have borrowed for consumption? How the same amount of borrowing might be classified as either consumption or production is often a question of when an individual has what money—loan funds or receipts from personal income—and what he uses it for.

To judge whether informal credit is for production or for consumption is very difficult. The most that can be learned in this regard is from examining the volume of money circulating in these rural areas and how

this money is affecting production. One has to examine whether it is increasing the net worth of the people, the players in the rural areas.

The next issue I would like to comment on is the notion that rural finance or informal finance is all credit. Sometimes, as others have indicated, there is money out there looking for a safe depository where people can keep it and withdraw it when they need it. There are also people who have money and want to invest it, but they are risk averse. So they are not going to put it in any institution or with anyone they do not trust. They will probably like to hold onto it. All these factors come into play in informal finance.

C. S. Kimei: I would like to ask Professor Shipton if he could tell us whether the form taken by savings depends on the motive. For example, if a motive is precautionary, then much of the savings will be kept in liquid form—and so forth.

My second question concerns the interaction between the rural informal financial market and the urban informal financial market or with the formal financial market in general. In some cases we see a lot of savings flowing from a rural informal financial market to the urban financial market, depending on whether it is a harvest season or a planting season.

Parker Shipton: On the first question, about the motives behind savings, the answer has to be a fairly complex one. The gist of it is that the motives behind what I am calling an illiquidity preference are as much social as economic. Rural people are always concerned not just with keeping their cash or hard goods in a form that will not deteriorate with inflation before they can use them but also with keeping them in a form that someone cannot beg away.

There is a widely recognized pattern in rural Africa, as you know, for poorer farmers to sell food cheaply after harvest and buy it back more expensively before the next harvest. Some more solvent rural people are able to serve, and profit, as something like food "pawnbrokers." To explain this, we are not just talking about cyclical poverty—a vicious circle of poverty that forces people to sell right after harvest when the prices are low. Though that is real enough, we are also talking about the "squawk factor" between neighbors if a farmer does not sell until everyone is hungry. The saver must ask, if he or she waits and sells the grain to buy a radio in the hungry season when no one has anything and the neighbors are begging at the door, will there not be damaging accusations and broken ties? From a purely social standpoint, then, it can make sense for an individual to sell low and buy high.

On the second question, not addressed in the paper, there is a considerable flow between the rural and urban financial "sectors" and also between the formal and informal (the very concept of sectors is pretty artificial). Between city and countryside, remittances change direction like tides but on a seasonal basis. Between formal and informal, cooperative

loans issued at 20 to 25 percent per annum are relent, sometimes in surprising ways, as when husbands relend to their wives at higher interest. This brings up again the issue of what the appropriate units of analysis are. If husbands are profiting this way from wives, one has part of an answer to the question, When is a household not a household?

Brian Ames: My question is an offshoot from Mr. Ndofor's question and the issues raised regarding productive versus consumptive use of credit in the informal sector.

My question involves the issues of maturity structure. In Cameroon the maturity structure of loans offered in the informal sector is very short term; usually six months, sometimes twelve, possibly eighteen months. This might in and of itself explain why these loans are used mostly for less than productive purposes. My questions is, Why is it that longer-term maturity structures have not been developed or evolved in the informal sector?

In the case of Cameroon this is a very important issue because there is a "missing middle" in the financial system. The commercial banks, as was discussed earlier, provide generally short-term credit aimed at trade finance. This involves a very quick turnover period and is often tied to various fee-based activities. This credit is not going into productive lending. In the informal sector credit is very short term and interest rates are really not an issue. The problem here is that the term structure is very, very short.

When we look at the potential productive activity in the economy, it is small and medium-scale enterprises that need credit to finance plant and equipment. These enterprises require roughly four- to five-year term structures on average to be able to repay. In either the formal or the informal market, the appropriate term structure for productive lending does not exist.

Parker Shipton: That is a particularly important point. There is certainly a "missing middle" in the credit market for small-scale infrastructural developments—small factories, machines like threshers, and so on. Practically no one will lend for such things in rural parts of East or West Africa with which I am familiar.

For Islamic settings in western Africa, I have tried to present a piece of an answer. Locally understood limits on *ratios* of interest to principal chargeable (rather than on *rates*) exert pressure toward smaller-scale, shorter-term lending. A large loan that takes several years to repay will accrue such high interest over that period—perhaps coming to well over 100 percent—that it is likely to be deemed usurious, even at what one of us here might consider a reasonable interest "rate" of accretion. It is going to lead to hardships for both borrowers and lenders. So there is a big gap there. The suggestion is not necessarily that somebody ought to fill it with credit but that doing so will be a major challenge. Larger means harder, and longer-term means harder. These are areas in which only the most solvent

institutions will want to become involved. Progressively graduated loans are likely to work best. There may also be other ways of finance that are better than credit for purposes like these: perhaps grants, hire-purchase agreements, or other arrangements.

Carlos Cuevas: Just one important distinction. In long-term lending the question is whether a large amount today is going to be repaid in three years in one single payment or in two or three payments, as opposed to a loan that can be repaid gradually.

The example I am thinking of is corn mills. Groups get together to purchase a corn mill, and they can start repaying the first month they are operating the corn mill. They set aside part of the proceeds from the operation of the mill and repay whatever debt was acquired.

I agree that large long-term investment loans, for cattle, for example, are more difficult to conceive under an informal market setting. Gradual investment in cattle is seen through short-term borrowing in Africa.

Clark Leith: One of the questions that struck me as I read this paper was the basic issue of whether this kind of small informal sector lending could in some way be extended as the paradigm for financial sector development. As I thought about it, it became less and less clear to me that it is something we can usefully use.

I would like to suggest some reasons why not, almost to challenge Professors Shipton and Cuevas to respond in a more positive way. What we see here is a situation in which we have very small, very segmented markets. In fact, the first preference is the kin, and that by definition is segmented. So we lose all the benefits that we understand come from financial systems: integration, size of the market, and competition. We get a picture here, in fact, of zero competition. Someone goes to that one rich uncle, and that is the first choice, regardless. If he cannot get it from him, he is placed in a very difficult position going down the line.

The absence of diversification of risk also has to be an important problem in kin-based lending situations. Further, there is the absence of the information content of an interest rate. The market interest rate, which I know every time I come up with a project I have to test against, is not there in these informal sectors, because interest rates are in fact secret. The information content about what is a good investment and what is not a good investment is missing.

The other question relates to the spatial dimension that does not seem to have been mentioned a lot here. In most of the situations that I am familiar with there is a lot of rural-urban migration. To what extent do these kin-based connections across rural-urban migration in fact assist in the integration of the economy? Does the absence or presence of the formal financial sector contribute to the smooth functioning of that?

Parker Shipton: Certainly, if we must talk about all credit as constituting a market—and to a degree I would demur—then it is a very segmented

one indeed, particularly where interest rates and ratios are kept secret. As for whether this adds up to an efficient system of financial intermediation, it is hard to answer; it is simply the one that is working.

To what extent can informal financial systems serve as a model for formal ones? Research in Cameroon by Steve Haggblade suggested that some rotating savings and credit associations (or tontines, locally called *njangi* groups among the Bamileke and others) have grown—he says "evolved"—into urban, Western-style banks. But they altered some of their methods in the process. They changed from single-sexed to mixed participation, they began using written records, and they adopted guarantee or chattel collateral systems as they began to deal in larger amounts. Elsewhere in the world institutional attempts to emulate principles embodied in local financial clubs seem to show some signs of promise. The celebrated Grameen Bank in Bangladesh and the Accion International/AITEK programs in Latin America have relied heavily on group peer pressures, like those underlying tontines worldwide, to ensure loan repayments. Whereas individuals take the loans, small groups of them are responsible for paying them back. No one else in the group can borrow until the first borrower repays. Essential to this system are the complex ties binding members of a borrowing group in other facets of life. They may be kin or belong to the same religious groups or sports clubs. They have ways of making life difficult for a defaulter among them.

Much room remains for experimentation with principles like these. While we do not yet know how extendable they are into formal financial spheres, there are clearly lessons to be learned from systems already working. Rotating credit and savings associations serve those ineligible for other loans, they require little or no paperwork, and they do not require travel. They provide occasions for social gatherings. They can make embezzlement difficult, since the transactions are likely to occur in a group meeting where everyone is watching as the money changes hands. Members can supervise other members' expenditures—something banks, more detached from local life, cannot so easily do. The groups can serve as a form of insurance, as members can renegotiate among themselves the order of cash withdrawals. These groups benefit from local commitment, being creations of their members themselves.

The financial systems that work in rural Africa usually combine savings and credit. In rotating savings and credit associations the two are the same transaction: the early receivers in the cycle borrow while the later receivers save. The amounts of credit are self-regulating: they cannot easily grow larger than borrowers can repay—a common problem in formal lending. There is another principle to note. In a larger financial institution a depositor acquires a stake in its sound working. Depositors can help watchdog local credit management. They can see activities that urban-

based institutional supervisors cannot, particularly where these are constrained by fuel costs and shortages from making the rounds in rural areas.

Many financial program planners are wondering now whether to try to plug into indigenous financial associations. Certainly some local, indigenous saving groups have successfully saved with group bank deposits. They are beginning to do this in The Gambia, and they make banking accessible to women who would ordinarily be unable to meet the minimum deposit requirements. For institutional credit existing local savings groups may be able to help implement group guarantees. But otherwise, if one of these small indigenous financial groups is working, why not leave it alone?

On the second question, the rural-urban capital flows that follow kin ties of migrants clearly assist greatly in integrating the economy. In some African countries, for instance Kenya, postal money orders are a standard means of urban-rural remittance. But there and elsewhere on the continent, foods and hard goods are also physically transported back and forth between harvest seasons and hungry seasons. When one begins to consider international labor migrations, major problems appear: how to get cash safely back to the relatives at home, across sticky borders and with converted currencies. Much is sent through traveling friends and thus sporadically. In The Gambia town merchants with banking savvy are brokering international remittances to farming families, but there is a real need for international financial services to expedite the process. Commercial banks operating in Africa could help more in this, and probably with profit.

177

7

Philippe Hugon

The Impact of Adjustment Policies on African Informal Financial Systems

In most African countries the financial system is inadequate for the needs of economic development. The bulk of the rural and urban population have no access to commercial banks or other official credit organizations. For them the informal financial system plays a crucial role in providing credit, a role that has grown as debt crises and financial imbalances have afflicted the official credit system throughout the continent.

Studies of the effects of restructuring official financial systems, as illustrated elsewhere in this volume by the cases of Guinea and Ghana, seldom address the impact of such changes on the informal financial systems that supply credit to most Africans. To redress the imbalance, this essay analyzes the effects of African countries' economic adjustment policies on informal financial systems.

Definitions; Problems of Studying Informal Finance

First let me define some of the terms I shall use.

Informal finance is financial activity that is legal but that is not officially recorded and regulated and that occurs outside official credit institutions

(Chandavarkar 1988: 1). Informal financial systems have several common features: cash transactions predominate; transactions are small scale; regulation and detailed record keeping are absent; entry into the business of informal lending is easy; lending and borrowing occur without recourse to official law and courts; and the systems operate within tightly knit communities.

Adjustment has become a term with many meanings. Sometimes it means stabilization; other times, structural changes that generate growth. In a broad sense it is the way an economy adapts itself to the international environment or, more precisely, the way the balance of payments moves from disequilibrium toward equilibrium. Whereas stabilization policies strive to limit aggregate demand, adjustment policies encourage growth in output and promote exports or promote import substitution.

Structural adjustment means adjusting the balance of payments by means other than reducing economic growth or by greatly increasing reliance on foreign investment. Permanent improvement in the balance of payments requires changes in the structure of production. African governments commonly make structural adjustments with the help of loans from foreign governments or international agencies. In contrast to project loans, structural adjustment loans are macroeconomic and are linked to changes in economic policy (they have "conditionality").

There are three major problems in studying the impact of adjustment policies on informal financial systems. The first is lack of information. Despite some recent studies by the World Bank and the Center for Development of the Organization for Economic Cooperation and Development (OECD), data on the various effects of adjustment programs are sketchy. We have macroeconomic aggregates for Keynesian national income accounts or monetarist monetary models but lack statistics on diet, employment, income, health, and education, all of which are relevant to informal financial systems because of the systems' social role, which I shall explain later. Moreover, available studies of informal financial systems are snapshots and do not show how these systems respond over time to adjustment policies. Furthermore, informal financial systems are, by definition, hard to observe.

The second problem is what limits in space and time to draw when studying adjustment. Adjustment loans that give access to foreign credit and monetary and fiscal policies that reduce demand or domestic credit have effects in the short term. Measures to change expenditures and reallocate resources have effects in the medium term. Organizational and institutional reforms often become effective only in the long term.

The final problem is one of attribution. The links between adjustment policies and their effects on informal financial systems are often hard to trace. Controlled experiments are impossible. Therefore, to judge the effects of adjustment policies, we can only compare the experience of

countries that have adopted adjustment policies with those that have not, study individual countries' experience before and after adopting adjustment policies, and assess the gap between goals and results.

Formal and Informal Finance

Informal finance in Africa has roots in precolonial forms of organization that have enjoyed renewed vigor as the newer official financial systems have broken down.

In most African countries the desired rate of economic growth exceeds the official financial system's capacity to invest. Official financial markets, which comprise the central bank, development banks, and commercial banks, are backward. The central bank's portfolio generally includes large holdings of government debt, whose quality is doubtful. Commercial banks specialize in short-term credits for business, trade, and agriculture but provide insufficient medium- and long-term financing, because of bad-debt risks and regulatory burdens. Development banks have open lines of credit from foreign investors to finance private sector investments, but their finances have deteriorated recently, partly because they have branched into unfamiliar fields such as mortgage and consumption lending.

Loans from abroad help official financial organizations, but most of the population lacks access to official finance. The official financial system serves only large companies and the richest individual borrowers. The majority of the population, both rural and urban, therefore resorts to the informal system. Informal finance operates within kinship networks or other communities where the character of borrowers is well known (Lelart 1984) and skirts official regulations and government supervision, thus reducing management costs to a minimum.

Diversity in Informal Finance

Informal financial practices differ significantly among the countries of sub-Saharan Africa. Community savings and credit groups are highly developed in West Africa but not in East Africa and Madagascar. Other important distinctions are those between egalitarian and hierarchical organizations, organizations whose ultimate purpose is investment versus those engaged principally in consumption or providing social security, and voluntary savings groups versus forced-savings groups.

To simplify (following Dupuy 1988), I shall distinguish three kinds of informal financial bodies and individuals' relationships with them. In Table 7.1 each kind of entity is less voluntary than the one to its right. Indeed, the fourth column simply exemplifies the relationship between an individual and a bank in the official financial system and is without the

TABLE 7.1
Types of Informal Finance

Community saving		Individual saving	
Associative savings group (obligatory for social purposes)	Contractual membership savings group (voluntary for individual purposes)	Collection agency (mediates the relationship between official bank and customers)	Bank-based (direct relationship between customers and financial institution)

group mediation that characterizes the three kinds of informal financial organizations.

Let us consider each of the three informal financial institutions, moving from left to right in Table 7.1.

Associative savings groups are those where members have a wider collective identity than that of being mere savers—for instance, they may be bound by kinship and religion—and where membership is obligatory. Each member has certain obligations and entitlements with respect to the community (Mahieu 1989). Obligations include ceremonial obligations, sending part of one's income to relatives (especially if one is a city dweller with relatives in the country), and taking on boarders or protégés in the city. Social pressure may compel people of high status to spend over 40 percent of their monetary income to satisfy these obligations. In return they gain acknowledgment as community leaders and gain entitlements (especially land titles) and the promise of support should they become poor. Those who do not conform to pressure to fulfill their obligations suffer sanctions: sorcerers try to work ill on them, they are denied burial close to their ancestors, and so on.

Membership in an associative savings group is not like a debtor-creditor relationship. The primary purpose of such groups is not to enforce loan repayments but to provide a type of social security and to redistribute income among members. This rationale is especially strong because the outside world is so uncertain in Africa and because African governments cannot afford comprehensive social security schemes themselves (Lespes 1988).

In contrast to associative savings groups, *contractual membership groups* are based on individual voluntary membership. The names of these groups are as varied as the languages and countries in which they exist: the *ekub* in Ethiopia, the *djangui* in Cameroon, the *kukoresana* in Zimbabwe, and so on. Relationships are contractual and for the purpose of saving only. The typical example is the tontine, which pools funds with or without rotating loans. Contractual membership groups generally serve homoge-

neous social groups. They employ an immense variety of methods that show their flexibility in adapting to local conditions. Access to capital by turns may be established by a predetermined order, by lottery, by consensus, or by auctioning to the highest bidder. Pooling may be accomplished on an egalitarian basis or, as with the *djangui* in Cameroon, according to variable contributions.

Lelart (1984) distinguishes three types of tontines. *Mutual tontines* are rotating savings funds in which levies benefit each member according to a predetermined order, which can however be revised. Loans do not pay interest. Mutual tontines affect the circulation of currency, since at each levy the funds collected are redistributed among the participants. *Commercial tontines* are based on fixed saving funds. They are administered by "money guardians" who receive contribution dues and grant loans. Commercial tontine subscribers therefore receive certain banking services. Loans and deposits pay interest. Deposits are more or less periodically made, and loans may be repaid before the scheduled date. Financial accumulation is not always regular, but it is of some consequence: in rural Niger, for example, the total deposits of a commercial tontine average about 500,000 CFA francs; for comparison, the legal minimum capital for an official financial institution is 10 million CFA francs (Liman 1988). In *financial tontines*, auctions determine the order of borrowing. It is particularly important to distinguish clearly between financial tontines' direct, collected savings and the interest collected on loans, which is accrued and fed back into the system.

The tontine form, then, is a continuum whose purpose ranges from social security based on community solidarity to pure financial gain based on utilitarian calculation. All forms of tontine promote security. A tontine group increases the power of each member. It does not provide long-term lending but provides short-term credit for members (Dupuy 1988).

In an uncertain world, where there is a strong preference for liquid funds (especially to meet survival needs), lenders' criterion for offering credit is how rapidly loans can be repaid or reduced in an emergency. This entails calculations of the sustainability of group funds, including estimations of the likelihood that a number of tontine members may have emergency borrowing needs simultaneously.

In addition to fulfilling obligatory and voluntary savings purposes, informal financial systems also meet trade needs that fall outside the scope of official regulations and controls, through *collection agents*. The distinguishing characteristic of these agents is that they have access to formal credit and are willing to lend money to those who do not. These are often merchants who lend their own capital or relend money they have borrowed from the official banking system. They do not accept deposits. They charge very high interest rates but lend without collateral or legal guarantees. To ensure repayment they rely on personal ties more than on

supervision of the use that borrowers make of the credit. They are flexible and rapid in their disbursements. They exist because households and small businesses that lack access to official credit prefer to have capital, even at high cost, than to have none. In many countries the credit to peasants is assumed by traders who control the import and export trade while also maintaining relations with the official financial system.

Other collection agents also accept deposits, which they may deposit in official banks. These agents, effectively, are private banks. Private banks include persons who are "money guardians," make loans, borrow from official financial institutions, and take deposits. Private finance companies make loans of up to three months. Cooperative groups, such as the savings societies of south-central Cameroon, tap a portion of rural savings without incurring the administrative costs of official savings banks.

Informal financial organizations adapt to the absence of formal legal guarantees. The flexibility they provide is maintained by a vast network of agents, messengers, and intermediaries who have connections with official finance.

Links between the Informal and Official Financial Systems

There are two conflicting interpretations of the links between the informal and official financial systems. One stresses legal restrictions; the other, market segmentation.

The legal restrictions interpretation explains the existence of informal financial systems mainly by reference to discriminatory price measures, government debt crowding out official private sector investment, and the sluggish management and high operating costs of official financial institutions. The official system's below-market interest rates induce an unsatisfied excess demand for loanable funds, thus bringing about the existence of parallel financial markets with higher, market-clearing interest rates. Government debt, the result of budget deficits and public enterprise losses, crowds out bank loans to the private sector, especially to small businesses. Compulsory bank loans to the public sector oblige banks, in the remainder of their portfolios, to emphasize short-term loans and to insist on higher-quality collateral than they otherwise would. The administrative sluggishness, high management costs, and payment delays of official banks prevent them from reaching small businesses. The banks' high transactions costs promote informal financial innovation.

Thus "financial repression," as McKinnon (1973) terms it, creates holes that the official financial sector does not fill. The informal sector compensates for the official sector's shortcomings. This interpretation is consistent with the theory of Gurley and Shaw (1960), in which financial intermediaries assume risk and make it possible to reconcile savers' demands for

liquidity with borrowers' needs for loans against assets whose liquidity is low. Financial intermediaries balance risk and reward. McKinnon extends the theory to developing countries, where financial intermediation is limited and where artificially segmented markets or financial systems lead to differentiated rates of return.

In contrast to the legal restrictions interpretation, the structuralist interpretation views informal financial systems as products of forces other than purely economic ones. According to it, informal financial systems are subordinate to official financial systems. Market segmentation occurs not because of regulation but because the informal systems' main purpose is to serve certain social goals rather than simply to make the highest profits. Informal financial systems redistribute income among community members. They provide a form of social security for members and meet members' fluctuating liquidity needs. They express solidarity based on kinship, ethnicity, or religion.

According to the structuralist interpretation, informal financial systems are offshoots of official systems in which currency has a greater velocity of circulation than in the official systems. Official monetary policy thus produces effects that informal financial systems diffuse (rather than counteract, as the legal restrictions interpretation suggests). Intracommunity transfers are linked to government transfers. Most government payments originate in marketing board or raw material purchases, but the recipients then redistribute income through the informal financial system. Hence policies that modify government transfers produce an effect on the informal financial system. Deposits depend on savings from rural and urban incomes; their total amount thus depends on household incomes.

The Need for Economic Adjustment

The adjustment policies enacted in more than half of all African countries since 1980 are responses to financial imbalances. Net investment from the rest of the world to Africa not only ceased but reversed. By financial liberalization, adjustment policies try to narrow the gap between official and informal savings and to create anew a favorable investment climate. Financial liberalization tends to bring part of the informal sector into the official economy. Furthermore, making financial markets freer increases the attractiveness of holding liquid funds. Those responsible for carrying out adjustment policies, however, may have motives of politics and personal or interest group gain that conflict with the proclaimed purpose of improving market efficiency.

The roots of the financial imbalances of the 1980s lie in the 1970s. The breakdown of the Bretton Woods system and petrodollar surpluses caused an increase in very mobile, short-term investment ("hot money") and in the role of international banks (as opposed to government agencies) in

financing investment in Africa. There was also a marked increase in African government guarantees of export credits and bank loans, owed mainly to wealthy countries. Domestically during the 1970s most African countries experienced falling rates of savings and local investment, accompanied by growing government debt. Governments financed budget and public enterprise deficits by printing money and by issuing securities on the domestic and international markets. Even countries using the CFA franc, which customarily have had more stringent monetary and financial controls than other African countries, circumvented the rules by increasing their public enterprise debts and foreign borrowing (Plane in chapter 10 of this volume).

Official policies favored below-market interest rates and the credit rationing that resulted for a number of reasons: to promote investment; to direct credit into long-term, low-return projects; or to prevent multinational companies from receiving better terms than local companies. These policies promoted external indebtedness, which favored capital-intensive investments over less capital-intensive ones. They also crowded out private savings in favor of public savings. Low official interest rates increased the loan repayment differentials between official bank credit and the much higher rates charged in the informal financial system.

In the 1980s the international credit system became less liquid, as growing U.S. deficits sucked in capital and as a number of third world countries defaulted on their debts. Though foreign aid increased and some debt was written off, African and Latin American countries suffered net outflows of investment.

In Africa today direct investment is lower than it was in the 1970s. Governments have ceased guaranteeing domestic loans. Adjustment policies have resulted in tighter credit controls along with higher interest rates (because real rates remain negative in many countries), privatization of the system, and deregulation. Africa's banking sector has become quite brittle. Because there are so many bad debts outstanding and payments owed by the government or by public enterprises, banks focus on short-term transactions entailing limited risk.

Adjustment policies aim at reforming the structure of the economy, replacing protected monopolies with competitive firms. By reforming the economy, they hope to reestablish equilibrium in the balance of payments and the domestic credit market and to establish sustainable economic growth. Demand management policies are the first step, but supply-side reforms of prices and enterprise management are also necessary.

Economic restructuring, liberalization, and changing the price system imply changing the social structures and the relations of power between the foreign trade and internal trade sectors of the economy, between the urban and rural populations, and between the private and public sectors. Economic liberalization aims to promote entrepreneurship and discour-

age rent seeking, to reduce the need to resort to parallel (black) markets, and to increase the economy's efficiency at allocating resources. Adjustment measures aim first to restore balance-of-payments equilibrium and, beyond that, to lay the groundwork for economic growth.

The imbalances that currently exist (represented in Table 7.2) are the result mainly of discriminatory domestic policies (managed prices, subsidies) and foreign trade policies (overvalued exchange rates, exchange rate controls, protectionism). Regulated sectors are thus favored over competitive sectors, government expenditures crowd out investment in the private sector, and redistribution prevails over production.

Adjustment Policy

Liberalization policy has several facets. One is opening the domestic economy to world markets. The rationale for this lies in the principles of comparative advantage, free movement of factors of production, and market-clearing exchange rates. Relaxing exchange controls, reducing tariffs, eliminating nontariff barriers (except on some key products), and readjusting exchange rates are complementary measures. They prevent sectoral imbalances and shift the terms of trade and productive resources from regulated sectors that produce nontradable or internationally

TABLE 7.2
Factors Contributing to Financial Imbalances

Causes	Symptoms	Effects	Indebted economy
Excess demand	Rise in money supply	Inflation	
	High salaries High government consumption	Budget deficit	
	Low saving	Saving-investment deficit	
Government-set, non-market-clearing prices	Low agricultural producer prices Subsidized public enterprise prices	Food shortage Public enterprise deficits	Government debt
	Overvalued exchange rate	Trade deficit	Foreign debt
	Negative real interest rates	Overcapitalized enterprises Low savings	Business debt

uncompetitive goods to competitive sectors that produce internationally tradable goods. Another facet of liberalization is domestic institutional reforms to restore the primacy of the market. Such reforms include freeing trade, reducing the government's role in the economy, and cutting fat from and privatizing public and quasi-public enterprises. Deregulation entails dismantling protective arrangements, subsidies, and price stabilization schemes. Rationalizing and privatizing the public sector increase efficiency and prevent the public sector from crowding out the private sector's investment needs.

Still another facet of liberalization is reducing and restructuring expenditures, including domestic credit. Doing so can restore both "internal" and "external" balance. To accomplish that expenditures must be reallocated, so that production in protected sectors falls and production in the export sector rises. Along with macro and micro measures to restructure demand, structural adjustment loans may be necessary.

As an example of the effects of restructuring expenditures and of liberalization policy generally, consider agriculture. Raising prices for agricultural products transfers income from cities to the countryside, promoting rural saving. Altering food supply channels by means of structural adjustment loans, temporarily rationing imported foods, and eliminating subsidies to consumers will change the terms of trade, leading to a reallocation of resources to agriculture. That will reduce the incomes of certain groups that now enjoy politically privileged positions (students, bureaucrats, the military, urban workers, the middle class) and increase peasants' incomes. By encouraging private agriculture, a green revolution can spur rural initiative and development.

Financial Liberalization

Financial liberalization can reverse the outflow of investment and the reluctance to make long-term investments that now characterize financially repressive economies. The legal restrictions interpretation of informal financial systems claims that there is a pool of savings, currently untapped, that financial liberalization policies can reach. Raising interest rates, lowering transactions costs (such as minimum capital requirements for banks), reducing public sector crowding out of private sector investment, privatizing state enterprises, and permitting competition in banking will eliminate the distortions that arise from financially repressive policies. That will encourage saving and reduce, even eliminate, the gap between official and informal financial markets.

Proper money supply and interest rate policies are essential preconditions for encouraging financial innovation. Keynesian prescriptions, which predominated during the 1970s, called for inflation, which was supposed to promote forced savings by redistributing income to economic agents with

a higher propensity to save. Orthodox, anti-Keynesian prescriptions, however, contend that inflation reduces the propensity to save, most notably by subsidizing urban dwellers, who have a high propensity to consume, especially to consume imported goods. Reducing inflation thus reduces the savings rates. Table 7.3 summarizes the contrast between the Keynesian financial repression position and the orthodox financial liberalization position.

Reducing money supply growth and pressure to monetize the government debt is easier if the government reduces its deficit. This in turn reduces crowding out of private savings. Raising interest rates to market-clearing levels encourages savings, promotes more efficient use of resources, and discourages overcapitalization. By making efficient finance profitable, it gives official financial institutions incentives to grow and to tap some of the savings now segregated in the informal financial system.

Financial deregulation and exchange rate adjustment complement money supply and interest rate measures. Deregulation reduces transactions costs of belonging to the official financial system by allowing competitors to establish low-cost alternatives to existing services. A market-

TABLE 7.3
Financial Repression versus Financial Liberalization

Financial repression	Financial liberalization
Analysis	
Negative real interest rates promote investment	Positive real interest rates promote real savings
Separation of official from informal financial systems as a result of market segmentation	Unity of markets because of absence of legal restrictions
Investment creates savings	Savings create investment
Separation of savings from credit; credit creates deposits	Deposits create credit
Policy	
Income transfer by inflation; selective credit policy	No debt monetization; tight monetary policy
No interest on consumer deposits	Interest on consumer deposits
Nonmonetary economy and scarcity of liquid assets require central planning; it is not possible to mobilize idle capital	Monetize the economy and create financial systems through decentralization; it is possible to mobilize idle capital
Financial institutions must precede financial innovation	A rise in interest rates makes financial innovation possible
Quantitative credit controls	Interest rates ration credit

clearing exchange rate can reduce capital flight. The combined effect of all these financial reforms is to blur the distinction between official and informal finance, to make financial markets more efficient, and to reduce black-market financial activity. There will be some differences between the adjustment policies of the CFA franc countries and other countries, as I have explained, because the CFA franc countries expanded government spending more by increasing the foreign debt of public enterprises than by resorting to inflation.

Results of Adjustment Policies

The short-term results of structural adjustment policies in African countries both confirm and contradict expectations (Jacquemot and Assidon 1988). This too should be expected: the results of adjustment policies can only be judged in the long term, after all the elements of a policy package have time to manifest themselves. Adjustment policies in the 1980s took place under unfavorable international conditions. Africa was becoming less important in world trade and was suffering a decline in real per capita income along with an explosion in the external debt and debt service. From 1980 to 1987, for instance, the real value of exports from Africa fell by over 50 percent, and the real value of imports fell by over 40 percent. Under such conditions adjustment policies' main effects are to reduce imports, investment, and government spending, rather than to cause a takeoff in economic growth.

Changes in Informal Financial Systems

The structural adjustment programs initiated in Africa have probably accounted for much of the rise in real interest rates that has occurred throughout the continent in the 1980s. The rise in real interest rates and the overall credit policy associated with adjustment programs have tended to reduce discrimination in favor of large enterprises and the public and semipublic sectors. Adjustment programs have decreased the gap between the official and informal financial systems. The overriding consideration weighing on both the official and informal financial systems, however, has been the burden of foreign debt. Adjustment programs have therefore made financial resources scarcer, decreasing the supply to official institutions. The crisis in government finances has reduced transfer payments and civil servants' salaries as sources of intracommunity transfers, and the consequent reduction of credit has affected the tontines. That is why Mahieu (1989: 22) writes:

> Community calculation [the social contract] and the resulting transfers [therefore] play a decisive and pre-eminent role in macroeconomic calcula-

tion in Africa. Any adjustment policy, whatever its theoretical foundations, that forgets this problem and lays the blame solely on the State for differences in incomes, risks worsening the instability of this type of economy.

The social welfare purpose of informal financial groups has become more important in relation to their financial purpose, as formerly well-off people have often found it impossible to fulfill their obligations to contribute.

The effects of financial liberalization policies may thus run counter to their intended goals, because of socially obligatory transfers, lenders' cautiousness, and pressure to redistribute income. Reducing civil service salaries or social expenditures may strengthen transfers within community associations or promote tontine-based finance at the expense of banks. Trade liberalization may strengthen the role of the trade intermediaries who operate between the official and informal systems; at the same time the reduction of official credit may offset this, decreasing liquidity in the informal system.

I now discuss some particular cases that illustrate the effects of liberalization policies on informal finance.

In Cameroon the general economic crisis appears to have spread to the informal sector. The informal sector has shrunk so that it is concerned mainly with providing rudimentary economic needs and has moved increasingly into pure black-market activity. The economic crisis and greater reliance on informal as opposed to government social security arrangements have somewhat revitalized the tontines. Bank savings have fallen, which favors the tontines. The financial troubles afflicting most households have reduced tontine savings, though, because in conditions of widespread shortages, people prefer more liquid assets.

In the Ivory Coast marked inequalities of income (the richest fifth of the population receive nearly 62 percent of total income) have traditionally been mitigated by income transfers, particularly by urban dwellers sending money to their rural kinsmen. This system of transfers has adapted to political centralization, to economic growth, and to urbanization, but prolonged disinflation is putting it under pressure.

In Niger it appears that adjustment policies contributed to the growth of the informal economy in relation to the official economy. There are several possible reasons for this: the informal sector concentrates more on imported goods than the formal sector (which is protected by tariffs); the informal sector obtains goods smuggled from Nigeria; and people have resorted to it as cost rigidities have made the official sector less competitive. It seems, however, that the informal sector in Niger is financed mainly by personal savings and personal loans and little by bank loans or tontines. The growth of the informal sector thus seems not yet to have encouraged the growth of informal finance at the expense of official finance.

In Madagascar, where savings groups and associations are not well developed, groups facing a marked decline in standards of living have changed their behavior toward family, work, consumption, and savings in order to survive. There have been pronounced increases in family instability (temporary or final separation), in lack of social cohesion (such as fewer family meals being eaten together), and in women and children in the work force. Births have also declined.

The search for subsistence income leads to the proliferation of small-scale activities that increase work hours and that favor cash- over barter-income-producing activity. It also takes the form of increased migration. While rural insecurity and malnutrition have encouraged migration to cities and exacerbated income inequality among peasants, migration from cities to the country has also occurred during urban rice supply crises. Traditionally migrations were mainly among cities, and rural emigration occurred in gradual stages and focused on small urban centers. Recently there has been a profound change. Annual migration, which amounted to 12 percent of the population in 1975, was estimated to be 29 percent in 1985, and all its components—intrarural, urban-rural, and rural-urban migration—have increased.

In response to the recent economic crises, Africans have adopted two types of survival strategy. One is regressive, characterized by resort to extralegal or illegal practices: crime, prostitution, child abandonment, child labor, and theft in cities; slash-and-burn agriculture, theft of crops and livestock in the countryside. The other strategy is adaptive, characterized by a search for supplementary income, reduced consumption, and drawing down savings or resources such as land and livestock. The search for supplementary income results in informal economic activity, in debt, in moonlighting, and in migration. Reduced consumption occurs by reducing luxury purchases but also by reducing food intake. Household size increases as more people postpone marriage, but the economy also makes families less stable. Increased differences between urban and rural dwellers increase the formation of a proletariat and concentrate land and livestock ownership in fewer and fewer hands.

Conclusion

Informal economic and financial networks embody kinship and community relationships that require a focus not on individuals but on groups and their organization in order to understand the effects of adjustment policies in African countries. Because of this adjustment policies are likely to have consequences in Africa unlike their effects elsewhere

Adjustment policies should have the following features:

- They must be specific to the country and to the type of activity. It is

possible to add to the features of the local culture and economy, to encourage them, but not to substitute for them. In this sense comparisons among experiences are illuminating for information or comparison but not as a basis for transposing experiences.

- Policies must take into account the diversity of situations. Access to credit must thus distinguish cases where people have no need of credit from those where they have no recourse to it; cases where it is necessary to break up usurious cartels by giving the poorest people access to consumption credit; cases where informal means of mobilizing savings (for example, tontines) may be turned toward long-term investment; and, finally, cases where new financial intermediaries must be founded to link financial institutions with the myriad of small productive units.
- On the whole, policies must encourage entrepreneurship. It is of course possible for policy to affect certain key economic groups directly, for instance, those involved in the most modern sectors (metalworking, repairs, and so on). For the most part, however, policies must reshape the economic environment by providing incentives for appropriate activity.
- Policies must set priorities for widening various bottlenecks: access to credit and technology, the demand problem, management problems, and so on. Experience shows that all these factors work in combination. To have access to credit, to change organizational scale, to modify one's tools, means to change the mode of organization and often to increase risks. To promote capital accumulation by increasing the division of labor, it is important to stabilize the labor market.

It is also important to establish interfaces between formal institutions and small businesses. The distance between the two is as much sociocultural as economic. Small businesses and large institutions should participate jointly in these interfaces. In the area of credit, mutual guarantee companies must make it possible for small businesses to gain credit without orthodox collateral. Changes in banking practices (like those of the Grameen Bank in Bangladesh) can also make possible access to credit for the poorest people (Nowak 1986, Chandavarkar 1988). In the area of means of production, locations for storing raw materials and leasing spare parts must promote accessibility and basic technical innovations. As regards training and management, service providers may meet needs on request. Access to information and to technology must make it possible to improve techniques and productivity at all levels and promote a range of technology making possible the replacement of human and animal energy by mechanical energy or to economize on firewood (to reduce the devastation of forests).

Stabilizing and maintaining credit-worthy demand are priorities. These

may be provided by channeling some foreign aid to small-business programs or by forming subcontractor networks within industry.

Finally, the reason for the success of informal finance is its flexibility and reliability. These, in turn, both reflect and reinforce social relationships. Therefore, to the extent that structural adjustment policies affect informal financial networks, they also alter the personal relationships among most Africans. This is why it would be hazardous to seek to formalize the informal.

-193'

Anand Chandavarkar

Comment

There is nothing in Dr. Hugon's paper with which I wish to differ. To my mind it is an excellent example of Cartesian logic, which I propose to supplement with some judicious Anglo-Saxon and Asian empiricism. I shall divide my comments into three distinct segments. First, I shall deal with some conceptual problems that I am afraid are neglected in the literature. Second, I will deal with links between the informal and formal sectors. And, third, I will try to formulate a policy agenda as a basis for further discussion.

As regards concepts, it is important to distinguish between two different segments of the informal financial sector. One I will call the "autonomous" informal financial sector, which exists independently of the degree of financial repression of the formal sector and historically antedates the advent of formal finance. The second segment of the informal financial sector is the "reactive" sector, which exists precisely because there are controls on the formal financial sector. The emergence of curb markets to circumvent credit controls, or credit ceilings, or interest rate ceilings is a good example of the reactive informal financial sector.

But it is also important to understand that the spread of financial liberalization is going to narrow progressively the gap between the formal and informal financial sectors. When economists like McKinnon and Shaw talk of financial repression in developing countries, they seem to have only the organized sector in mind, because, to my mind, the informal sector in developing countries is, if anything, a perfect example of a totally unre-

pressed economy, which is not subject to capital or reserve requirements, or to inspection, or to any central bank procedures.

Now we turn to the issue of linkages between the formal and informal sectors. Here again the economics profession seems to be subject to a degree of schizophrenia. On the one hand, when we tend to follow general equilibrium analysis, we say finance is fungible. When we observe the marketplace and do empirical testing, on the other hand, we seem to discover that markets are segmented. What then is the reality? In fact, I propose to advance a proposition that might sound controversial. It is this: that far from there being any segmentation dividing the formal and informal sectors, there is an impressive range of strong linkages between them.

First, this linkage derives from the fact of interlocking credit, commodity, and labor markets, which also explains the social rationale of many of the rotating credit associations.

The second linkage is the reciprocity of savings and credit facilities in both sectors. Quite often transactors operate simultaneously in both the formal and the informal markets. For instance, typically even a village moneylender will have an account with a joint stock commercial bank. He might borrow from the bank and lend to his customers. And I would further submit that the informal financial sector is more a vehicle of credit mobilization than of savings mobilization. Typically the attraction of the informal sector is the credit facility that it offers to borrowers who have no access to formal finance. The other aspect is the importance of the availability of credit as distinct from its price. That explains why, despite the very high rates of interest in the informal sector, borrowers still turn to it for credit.

There is also the very interesting feature, noticed in Asian countries like India and Korea, which suggests that the informal credit market in the urban centers has been an ideal mechanism for circumventing credit ceilings imposed on the formal sector by the central bank. I invite your attention to a study by Professor Yung Chub Park, which shows that the high rate of growth of the Korean economy has been sustained precisely because the credit ceilings on the formal sector were circumvented by extensive recourse to the informal credit markets. I would turn to Professor Hugon to ask whether a similar phenomenon has been replicated in Africa.

This brings me to the last segment of my presentation: What policy implications can we draw from the literature and from the discussions?

The first question is, What should be the ideal stance of the central bank toward the informal financial sector? As a former central banker, I can testify from personal experience to the fact that central banks' attitudes toward the informal financial sector typically gravitate between prejudice and hostility and benign neglect. But both are very unproductive postures.

And we must ask the question, What role can the central bank play in fostering competition between the formal and informal sectors? One possibility is the removal of legal obstacles to the more efficient functioning of the informal financial sector. For instance, take the case of lease financing. If the informal credit sector wants to go in for lease financing, would it have any problems establishing titles and getting enough collateral to execute lease finance? Similarly, if any documentary credits are generated in the informal financial sector, would the central bank be able and willing to rediscount this paper? I do not recall any Asian central bank—with the possible exception of the Bank of Thailand—having a special cell dealing with the informal financial sector. Informal financial activity is virtually equated with illegal financial activities. Central banks do not draw a distinction between informality and illegality.

Conceding the informal financial sector's economic rationale and efficiency, there remains another question: Is it not subject to limitations of scale? It consists essentially of retailers who are best suited to operate up to a certain scale of operations of their borrowing customers. In fact, I posed this question to Professor Yunus, the architect of the successful Grameen Bank in Dhaka, when I visited him some years ago. I asked, "What happens to the clients of the bank when they wish to enlarge their scale of operations?" He answered that they were then expected to turn to the formal financial sector, because their operations were geared essentially to the requirements of small-scale borrowers. They implicitly observed the principle of graduation.

Complementing this answer to the scale question is the study of Ian Little for the World Bank on small-scale manufacturing. It clearly establishes the important role of the informal sector in start-up finance for small-scale industries. But when they reach a certain minimum scale of operation, then they can no longer draw on the informal financial sector because of its lack of reserves. So our research agenda should assess what role the informal financial sector can play, given the increasing trend toward liberalization of the formal sector, and what role the central bank and the monetary authorities can play to foster the comparative cost advantages of the formal and informal financial sectors.

Discussion

Joshua Greene: I would like to build on Mr. Chandavarkar's comments by picking up on a question that Brian Ames raised earlier on. Namely, if we know that informal financial organizations in Africa are best able to handle fairly short-term loans of a small size, particularly for certain types of start-up activities, and we also know that the commercial banking sector, for a variety of reasons, is reluctant to engage in lending of more than, say, trade credits, seasonal crop finance, or perhaps activities of up to two years, then what institutions are there to finance the start-up costs or even the continuing costs of small-scale organizations that may need three-, four-, or five-year loans?

I think back to the experiences that I had in Lesotho, where there was a small agency to handle this but with little money. Are there projects under way that, say, the World Bank or the Agency for International Development (AID) or other donors are funding to try to fill this kind of gap for medium-term development loans to emerging business organizations?

Jerry Wolgin: It has traditionally been a role for the public sector, the finance institutions, and the failure is rife. I do not know of any private sector alternative.

Warren Weinstein: There are some efforts to fill this gap by working with some of the private voluntary organizations and, certainly in Kenya, efforts at some venture capital.

Inside AID we are thinking of starting a venture capital initiative and simply beginning to look at the potential. We are looking at investor groups

(the three that are furthest along are in Senegal, Ivory Coast, and Cameroon) as a vehicle by which some institutional support might be provided. We are also working with the International Finance Corporation (IFC) on this and are contemplating adding a venture capital aspect to it, providing some funds so that the private sector might start to bring into play some medium-term capital as equity, if not always as credit. There could be a combination of the two.

Alan Gelb: To follow up on that, one notices numbers of experiments going on, but it is very important that effort go into monitoring them properly and trying to draw lessons from them. One seldom hears about their outcomes because the time and effort to follow through are rarely taken. There is a role for research in such areas and a need to coordinate it with the initiatives.

Patrick Honohan: I understand that the IFC's Africa Project Development Facility has encountered this difficulty. They are able to find what appear to be viable projects that should be able to attract equity finance. But they insist that the equity for financing them be largely from Africans, and in many cases, though the projects are there and though the IFC's credibility is behind them, the equity funds are not forthcoming.

This seems to be a mysterious gap in some respects. Here are people who are not resistant to outside equity. They have come to the IFC with their projects and are prepared to share their equity with outsiders; so it is not the problem that you hear that people want to own a project themselves and are prepared to take loan finance but not equity finance. The demand for equity finance is there, but the supply is not forthcoming.

It is not clear why that is. Is it again a problem of contract enforcement, that at least with a loan one knows when one has not been repaid, but with equity one does not know whether the return is yet to come?

Turning to the question of interest rate setting and the linearity of interest rates that Professor Shipton raised earlier—he presented this, if I am not mistaken, as a challenge to economic theory. I wonder, is it so much of a challenge? May I just suggest three points about it?

First of all, if he is implying that linearity of interest rates is some Western hangup having no more logic to it and being just as arbitrary as anything else, that is obviously not so. I doubt if he has any examples where people in advance have said: "You can have this loan for 50 percent, but you can decide to give it back next year or the year after; I don't mind which."

The flexible duration that he has observed is an ex post thing; it is a renegotiation. Thus: "Okay, you can't pay it now, but maybe next year." Why might that be? It is because a component of the interest is not interest at all in our sense. It is really a contribution to a sinking fund for loan losses. Why do we not have that in Western banking? Because the loan loss provisions are very small. They are a negligible part of the interest that is paid in

commercial banking transactions. But they are a huge part of the interest in the informal sector. So I do not think there is any real puzzle there. Likewise with the seasonal loans. It is true that there is not a market between one part of the hungry season and another part of the hungry season. There are effectively only two dates in the year, hungry season and plenty season. So again, in an extended sense, the linearity prevails.

Finally, on interest rates, I was surprised to hear two speakers earlier insist that lenders are the price setters in these informal markets, because I had heard with great interest of the convention in these large urban tontines in Cameroon of bidding for the pool, which I thought was very interesting and suggested a richer range of things than just simply the moneylender approach to interest rate setting. This is where the group of people get around a table, and the money to be borrowed is there, but the potential borrowers make discount bids on the money. What is left at the end of the day is spent in entertainment, but the borrower has to pay back the whole amount that was on the table, even though he has only been able to get a discounted sum to borrow.

Parker Shipton: Agreed, economics has some useful tools of analysis for understanding African interest charges. It is a question of which tool to use. My suggestion is that the "rates" tool is being overused and the "ratios" tool is being underused. Understanding African thought about interest requires both, since many rural Africans do not automatically convert all calculations to linear rates. For many the ratio of interest to principal as it is finally paid matters more than how fast it accrues. In The Gambia, for instance, a one-year loan at 50 percent annual interest is deemed fairer than a two-year loan at the same annual interest. This helps explain frequent write-offs of old loans; lenders do not want to be publicly exposed as usurers once interest has mounted up to forbidden ratios. Moreover, in The Gambia, and perhaps in other rain-fed settings, borrowers and lenders sometimes agree on loan interest charges that accrue stepwise upon harvests, not by constant, linear increments.

Local loan interest, where charged, is negotiable, but in contexts I have known lenders are usually the stronger price setters in dyadic credit. In food shortages or other times of special need among their borrowers, they can stiffen their terms.

The Cameroonian urban tontines (*njangi* groups) should not be considered representative of all "informal" lending in Africa or even of African tontines. Indeed, they are more comparable to the elaborate ones, with auctions and interest charges, found in the Pacific rim of Asia. Their bidding system is unusual for Africa. Most African tontines appear to have fixed orders of rotation, and many have fixed contributions and withdrawals. They are generally simpler than those of urban Cameroon. But discounting principles analogous to the one Mr. Honohan mentions apply

in some African settings where bribes are paid for institutional loans. Some cooperative lenders in western Kenya appear to prefer borrowers who will pay them something privately off the top of their loans but who will agree to repay the whole amounts officially recorded as lent (with all the interest).

Jo Ann Paulson: Mr. Chandavarkar pointed out that informal markets may not be as fragmented and segmented as we assume in our analysis. I was surprised, however, by how many contracts that I expected to find were missing in the informal markets in Kenya. I could not always understand why. Input supplier's credit, which is a normal part of an informal market, was not there because the government controlled a significant part of the input markets. The Asians in private marketing were afraid that the government would not enforce their credit contracts. And there were very few interlocking contracts. In the areas without land markets one finds very few complex contracts over other factors. I think many contracts were not written because of a lack of enforcement mechanisms in informal markets once one moved away from kin and social groupings.

We have talked more about western African informal markets, which tend to have a fuller range of contracts and financial arrangements. In those markets one can leave a lot to the informal markets, where transaction costs are lower than in formal markets. We have to be careful in our assumptions about the informal credit market in East Africa, where informal markets are thinner. What, in addition to government infringement, has kept those informal markets from developing? I wonder if anyone else has found informal markets very segmented and incomplete.

Warren Weinstein: Much of Hernando De Soto's work in Peru's informal sector has examined the issue of contracts and their enforcement and things that are missing or, if they are coming into play, the means by which they may be made to stick, especially as the contracting participants enter into larger kinds of transactions.

Extending a bit the previous discussion of missing finance beyond West Africa, we found Barclays in Swaziland (southern Africa) deciding to allocate to some local Swazi a part of the funds that it normally just gives away for good works and good will, the purpose of the Swazi being to start up a sort of venture capital fund. This way the bank would give the money to them, have them play the intermediary role, do the start-up, watch, and ask them to come back after a year. If they had lost the money, it did not matter to Barclays because it was planning to give the money away anyhow. If they did make money, then Barclays has said it will finance them a bit further. This presents one approach that banks might take as a way of bridging between the formal and the informal.

Another issue that we have not addressed adequately—and I am not sure how one does—is the legal and regulatory environment and the extent to which that allows for or creates problems for efforts at bridging.

In Senegal, for example, the L'Financier movement used the tontine approach, first, and collected a lot of money. When they had it, it was put into another fund for investment. They created themselves as a fixed capital company. But then, as they continued to collect money, they found that they could not just put it into the investment fund. Because they had not looked at how the laws operate, they lost a few years of collection and have a blocked account. They now realize that they will accumulate savings every several years and then do a capital increase. It costs them more in legal fees.

There are traders in the franc zone who are unable to get trade credits, even though we have all said around the table that banks tend to provide them. For some of the informal sector they are not easy to come by. Among the additional efforts being made is one that Mr. Diop, from the Banque Internationale pour L'Afrique Occidentale (BIAO—AFRIBANK), might want to talk about a bit more. It involves using the block account as a guarantee so that informal groups can use this account to get trade credits and then possibly at some point bringing in a guarantee behind that guarantee to increase the leverage. We have been stymied so far because the legal framework does not allow for this kind of organization; something either is a bank or is not a bank. The flexibility that is required to get more of these linkages going appears to be absent in the legal and regulatory frameworks of a number of African countries. So I would agree that the legal and regulatory environments warrant more study and analysis if we are to see significant expansions of both participants and money in African financial markets.

J. O. Sanusi: Throughout our discussions we have not really looked at the future of the informal sector. We know that the informal sector is dominant in Africa because of the inadequacy of the formal financial system. The question I want to ask is, What future do we see? Are we expecting that the informal sector will fade away with better development of the formal sector? And if it exists at all, what is the situation of the informal sector in the industrial countries?

Alan Gelb: This is a very important question. Many of the functions of informal sectors are not, in fact, carried out in industrial countries by banks at all. Some are carried out by social security or by insurance. One should look at the informal sector and the formal financial sector with a much broader perspective in terms of the functions of the various components.

Nancy Benjamin: On the subject of this gap in financing, the operations evaluations unit at the World Bank might do a study of their loans to small and medium-scale enterprises and see what that experience has been. They might see if they have been able to help fill in the gap. I have read about some charitable organizations that give start-up loans on the order of $200 or so; if the one-person operation is still in business a year later, they will give them another $200. Maybe that is filling in a few places.

Alan Gelb: This does seem to be an area where linkages should be sought between researchers and people who are in the process of initiating various approaches toward these problems. This is a very fruitful area for case studies and for trying to link them together.

Jerry Wolgin: If you go to a place like Guinea, you see all this informal activity taking place in the informal goods sector, people producing at very low levels of capital, all kinds of activity taking place. I wonder what linkage there is between that and the informal financial sector. That is, to what extent do these small-scale firms, nonagricultural firms, require credit and capital from other sources than their own funds or maybe their own close network of relatives? Or, conversely, to what extent do these enterprises depend on an informal financial system for either starting up or continuing to grow, or both?

Carlos Cuevas: In Niger we found some strong linkages between wholesalers and retailers, with small retailers being funded through wholesaler trading.

Jerry Wolgin: Do you know of any sort of leasing arrangements at a very informal level between, say, manufacturers or owners of small-scale capital who lease out taxis or other equipment to individual operators?

Ali Abdi Amalow: These leases exist but are often not written. They are enforceable by traditional laws and so on, and this is where the issue of informal financing gets a little bit more complex. While we think of informal financing among friends and relatives, over time that initial population expands. The same principle—knowledge of the client—operates as it does in the formal system. And how, in the informal system, does one get to know that client? He becomes a friend of a friend or a relative of a relative. So the group grows. There are various players in the informal system, then, besides the moneylender. The tontines originate sometimes like small family groups and then grow wider to include friends; twenty to twenty-five people is not uncommon. And they are not all relatives; they are friends.

Things like leases exist and have been enforced. A form of securities is sometimes used called postdated checks, which are actually promissory notes, and these are used quite effectively. When there is a default, they actually enforce it.

Mohamadou Diop: In Senegal it is necessary to differentiate between the traditional African solidarity, which cuts across ethnic groups and social groups, and the tradition of self-financing among families and other groups.

I would venture to say that the paper of Professor Shipton missed one point. From a sociological standpoint, there is in West Africa a General Agreement on Tariffs and Trade (GATT) system that usually cuts across ethnic groups. The GATT system is really a reflection of corporative organizations, of woodcutters, smiths, jewelers, and what have you; these people have traditionally had their own system of financing that has

survived and become increasingly sophisticated. But in a context where we have a highly developed legal system, as in Senegal with its legacy of financial administrative controls, such traditional finance may not be acceptable to legal authorities.

Some three years ago the government in Senegal took very strong measures against what were identified as usury practices. This came about because of some linkages between the formal and the informal sector that had developed to the point where the repayments of loans by borrowers in the informal sector were being ensured by formal sector obligations.

One aspect of the system was that goods were used instead of money. A teacher, for example, might go to a merchant to borrow 10,000 francs for a family social event. Instead of being directly lent the money, the merchant would "sell" him cigarettes costing 20,000 francs in exchange for the borrower's IOU note in that amount for the "purchase" *and* the immediate resale of the cigarettes back to the merchant for 10,000 francs. This practice was so prevalent that productive investments were also often financed that way.

The rates of interest usually were close to 100 percent. For salaried people, of course, such rates were so burdensome as to be abusive. But the interconnection between the formal and informal sectors and the government of Senegal's intervention came about because the sophistication of the system reached a point where teachers and local civil servants were assigning their salaries in their banks in favor of the trader. At the end of the month, when the teacher, for example, went to cash a check, the banker would tell him that he had no money, because 100 percent of his salary was already assigned to various merchants. Merchants and bank employees were thus working in collusion but in violation of the laws in Senegal that forbid taking more than 30 percent of the salary of an individual. The problem was especially common in the rural areas, and many of the victims of some of these usury practices were civil servants, mainly teachers. The problem became so acute that it became a political issue, and the teachers' union asked the government to intervene to clean up the system. The government now has a panoply of laws against these practices.

In the productive sector what is happening now is that we have local self-liquidating types of operation, in which the banking system intervenes only as a depository of the excess liquidities coming from these operations. In my judgment, this money (less the interest it accrues on deposit) represents the counterpart of the nonperforming loans from which the banks are suffering. In my judgment it runs into the billions of CFA francs. It is a tremendously important sector. We know about it because many of the borrowers who have nonperforming loans in Senegal and in other French-speaking countries are still operating in broad daylight very profitable operations; but because those loans were not, in the first place, self-liquidating, they were not materialized, in some instances, by very solid

legal documentation. The banks are legally unable to seize assets of those operations.

This is an area that deserves substantial research. There is a great deal there, because it is the only explanation for the fact that, in a country where 30 to 40 percent of the banking portfolio is affected by arrears (is nonperforming), there is at the same time a very lively informal sector at every level, from the lowest to the highest.

205

8

Joshua E. Greene

Inflation in African Countries: General Issues and Effect on the Financial Sector

Since the period of the first oil shock in the mid-1970s, African countries have experienced a considerable amount of inflation. Inflation rates of 20 percent or more a year have been common for many African countries during the past fifteen years, and a few countries have even experienced rates in excess of 50 or even 100 percent a year. The persistence of inflation has had important repercussions for African countries, affecting economic performance in a variety of ways. The financial sectors of these countries have felt a significant impact from the continuing inflation, as have other macroeconomic aggregates—consumption, savings, and investment—and the foreign exchange markets in some countries with particularly high inflation rates. Despite the awareness that Africa has an inflation problem, there is remarkably little analysis of the phenomenon to date.[1]

This paper examines the inflation problem in Africa (excluding South Africa) and in sub-Saharan Africa.[2] Except for a discussion of cross-country inflation rates, the analysis focuses on inflation in Africa generally, using as a basis comparisons between groups of countries with relatively high and more moderate inflation rates. Differences between individual African

countries regarding the sources of inflation are not explored, although the importance of various factors no doubt differs from country to country.

The next section of this paper reviews recent trends in inflation in Africa, examining the data both for individual countries and for groups of countries with relatively high and more moderate inflation rates. The third section examines the possible causes of inflation, focusing on the different contributions of monetary expansion, fiscal deficits, exchange rate adjustments, and other factors to inflation in high- and moderate-inflation countries. The fourth section then turns to a discussion of the effects of inflation on the financial sectors of African countries. The discussion in this section is necessarily somewhat speculative, since most of the available information is qualitative and anecdotal. Various policy measures available for reducing inflation in African countries and what their possible effects could be on the financial sectors of these countries are discussed in the paper's fifth section. The final section contains some concluding remarks.

Recent Trends in Inflation in African Countries

Official price data for most African countries must be evaluated with caution for at least two reasons.[4] First, in many countries price indices record prices only in the capital city or urban areas, and the weights attached to various components have not been revised in many instances for long periods of time, sometimes even several decades, to reflect changes in consumption patterns. Second, price indices often reflect the official prices of goods subject to price controls, rather than actual prices of goods as sold in popular or rural markets. Both these factors impart a downward bias to measured prices and inflation rates.

Despite these provisos, it is clear by all accounts that African countries have experienced significant inflation since the period of the first oil price shock in the mid-1970s. According to the data in the International Monetary Fund's *World Economic Outlook* (IMF 1989), the rate of consumer price inflation in sub-Saharan Africa, as measured by a weighted average of individual country data, averaged more than 20 percent a year during the period 1981–1988 and significantly exceeded that level during 1981, 1983–1984, and 1988 (Table 8.1). For all of Africa (excluding South Africa), inflation rates in certain years have been almost as high as those for sub-Saharan Africa, the period average being about 17 percent.

As shown in Table 8.1, since 1981 Africa's inflation rates have averaged somewhat less than those for all developing countries, mainly because the figures for developing countries as a group reflect the large weight of high-inflation countries in Europe and Latin America. Inflation rates of African countries have been somewhat higher, on average, than those of Middle Eastern countries (16 percent), about twice those for Asia (9 percent), and three to four times the average for industrial countries (5 percent). At the

TABLE 8.1

Inflation Rates in Africa and Other Country Groups, 1971–1988 (annual percentage change in consumer prices)

	Average 1971–80[a]	1981	1982	1983	1984	1985	1986	1987	1988	Average 1981–88[a]
Africa[b]	15.2	22.4	12.6	19.7	23.8	12.4	13.2	14.7	19.8	17.2
Sub-Saharan Africa[c]	17.2	25.7	14.0	24.5	29.4	13.4	14.2	18.2	24.9	20.4
Developing countries by region	20.5	25.8	25.2	32.4	38.2	39.7	31.1	40.5	67.1	37.0
Asia	10.5	10.4	6.4	6.7	7.3	7.1	9.1	9.8	14.6	8.9
Europe	13.8	23.6	33.1	22.8	25.4	25.5	24.8	30.3	49.3	29.1
Middle East	13.5	15.1	12.9	12.0	14.4	17.0	18.2	19.3	18.8	15.9
Western Hemisphere	39.8	60.8	66.8	108.6	133.0	144.9	87.8	130.0	277.6	118.6
Industrial countries	8.7	10.1	7.5	4.9	4.7	4.1	2.3	2.9	3.2	4.9

a. Compound annual rates of change.

b. Excludes Angola, Namibia, and South Africa.

c. Excludes Algeria, Angola, Morocco, Namibia, Tunisia, and South Africa.

SOURCE: IMF 1989.

same time inflation in Africa has averaged less than that of developing European countries (29 percent) and far below the average rates experienced by developing countries in the Western Hemisphere (119 percent).

A closer look at the data in individual African countries indicates that the average inflation rates of 17 to 20 percent largely reflect the experience of a smaller group of countries with very high inflation rates. As indicated in Table 8.2, inflation rates in a group of twelve countries with annual inflation of 20 percent or more during at least four years since 1980—Ghana, Guinea, Guinea-Bissau, Mozambique, Nigeria, Sierra Leone, Somalia, Sudan, Tanzania, Uganda, Zaire, and Zambia—have averaged nearly 27 percent a year since 1975. Except for Nigeria all these countries have experienced inflation rates in excess of 30 percent during most of the 1980s, with the average for 1981–1988 more than 40 percent once Nigeria is excluded. In Sierra Leone and Zaire the average inflation rate during 1981–1988 exceeded 50 percent a year. In Uganda the average was more than 100 percent a year, with inflation exceeding 120 percent annually from 1985 to 1988. As shown in Table 8.2, inflation accelerated noticeably in many of the high-inflation countries during 1986. Inflation rose further in 1987 and then receded somewhat in 1988. These trends are masked to an extent by the heavy weight given to Nigeria in the composite figures shown in Table 8.2. In Nigeria inflation remained fairly modest between 1985 and 1987 (averaging 7 percent per year) and then accelerated to more than 30 percent in 1988.

Inflation rates for the remaining African countries were significantly lower during 1975–1988, averaging about 12 percent a year during 1975–1980 and 9 percent during 1981–1988, the latter being about twice the rate for industrial countries during the same period. The comparable figures for the sub-Saharan component of moderate-inflation African countries were 13 and 10 percent, respectively. Nevertheless, twenty-one of the thirty-five moderate-inflation countries in sub-Saharan Africa experienced at least one year of 20 percent inflation during the 1975–1988 period: Burkina-Faso, Burundi, Cape Verde, Chad, Comoros, Djibouti, Equatorial Guinea, Ethiopia, Gabon, The Gambia, Ivory Coast, Kenya, Madagascar, Malawi, Mali, Mauritania, Niger, Sao Tome and Principe, Senegal, Swaziland, and Togo. Eleven of these countries experienced inflation of 20 percent or more in two or more years, and six (Cape Verde, Equatorial Guinea, The Gambia, Madagascar, Mali, and Niger) had inflation rates of at least 20 percent in three or more years, including at least two consecutive years. Three countries had inflation rates above 20 percent for four years in the period: Cape Verde (1975, 1981–1983), Equatorial Guinea (1982–1985), and The Gambia (1975, 1985–1987). Only one of these countries, The Gambia, had an inflation rate averaging more than 15 percent a year during the period, although its inflation rate for the entire 1975–1988 period was still smaller than that of any of the countries in the high-inflation group.

TABLE 8.2

Inflation Rates in Selected African Countries, 1975–1988 (annual rates of change in consumer prices)

	Average 1975–80	1980	1981	1982	1983	1984	1985	1986	1987	1988	Average 1981–88[a]
High-inflation countries	26.6	21.9	33.4	14.5	31.7	39.4	15.8	17.9	26.2	37.0	27.0
Ghana	61.3	50.1	117.4	22.1	123.1	39.7	10.3	24.6	39.8	31.4	44.8
Guinea	11.6	40.0	35.0	29.9	30.3	26.0	19.0	68.4	36.8	27.8	33.5
Guinea-Bissau	16.4	64.8	45.5	16.5	23.3	65.0	45.0	37.0	106.7	66.0	48.4
Mozambique	2.0[a]	2.0[a]	2.0[a]	18.6	28.1	30.3	29.2	38.7	166.0	50.1	39.6
Nigeria	19.8	10.0	20.8	7.7	23.3	39.5	5.5	5.4	10.2	32.9	17.5
Sierra Leone	15.0	12.9	23.4	26.8	88.6	66.6	76.6	80.9	178.7	37.4	64.5
Somalia	21.8	59.0	44.6	22.6	36.4	92.3	37.7	35.7	28.1	82.2	45.7
Sudan	20.1	26.5	24.0	26.6	30.6	33.7	45.6	23.3	19.5	41.2	30.3
Tanzania	16.4	30.2	25.6	29.0	27.0	36.2	33.3	32.4	29.9	25.1	29.8
Uganda	77.3	99.2	108.5	49.4	24.1	40.5	126.8	179.6	256.0	123.0	101.7
Zaire	60.8	46.7	35.4	36.3	77.1	52.2	23.8	45.7	90.4	82.0	53.7
Zambia	14.3	11.7	14.2	12.3	19.7	33.0	34.2	51.6	57.0	50.1	33.0
Countries above excluding Nigeria	37.6	41.3	56.0	27.9	50.2	39.1	38.7	44.4	58.4	44.8	44.9
Other countries											
Africa[b]	11.5	10.6	12.3	10.6	8.1	9.4	9.3	9.3	6.1	8.2	9.2
Sub-Saharan Africa[c]	12.8	11.5	11.5	12.8	10.4	11.1	9.9	8.7	6.4	8.7	9.9

a. Staff estimate.

b. Africa as defined in Table 8.1, excluding high-inflation countries.

c. Sub-Saharan Africa as defined in Table 8.1, excluding high-inflation countries.

SOURCE: IMF 1989.

Factors Responsible for Inflation in African Countries

A variety of factors have been responsible for inflation in African countries. As noted in a recent World Bank study of inflation in Zimbabwe (Chhibber et al. 1989), the mechanisms giving rise to inflation in individual countries are complex, frequently involving a combination of monetary and cost-push factors, and are influenced by exchange rate developments and changes in price control regimes. Nevertheless, recent theoretical and empirical work on inflation has identified at least three models, not necessarily independent, for explaining the acceleration of inflation in individual countries. One is a straightforward monetarist model. The second, which can be termed a fiscal approach, acknowledges the role of money in inflation but identifies large fiscal deficits as the underlying cause of monetary expansion. The third approach focuses on the role of exchange rate depreciation, either in conjunction with monetary policy or as an influence on other factors feeding into inflation. In addition to these three complementary approaches, claims have been made for other variables as factors behind the rise in African inflation rates, including increases in import prices and increases in domestic incomes arising through higher wages and agricultural producer prices.

First, and perhaps best known, of the various inflation theories is the monetary approach. This reflects Milton Friedman's well-known adage that "inflation is always and everywhere a monetary phenomenon." According to this view, inflation should be positively correlated with rates of monetary expansion, the most inflation-prone countries experiencing the largest rates of monetary growth. Moreover, as the increase in the money supply can come from various sources, it is the monetary growth that matters, rather than underlying factors that may be responsible for it.

The second approach attempts to look behind simple monetary-inflation correlations to identify the source of monetary expansion in large fiscal deficits. As summarized in a recent paper by Montiel (1988), proponents of this view base their arguments on theoretical models in which fiscal deficits are the major cause of monetary expansion. In these models the ratio of the fiscal deficit to gross domestic product, in the context of rational expectations and a Cagan semilog money demand function, ultimately determines the economy's inflation rate. Since government deficits have been relatively large in many African countries, this fiscal model also has appeal.

The third theory of inflation emphasizes the contribution of the balance of payments, particularly the exchange rate, in generating price increases. In this approach exchange rate depreciations are seen as contributing to inflation either through an increase in inflationary expectations or through a worsening of the government's budgetary position that is later accommodated by monetary expansion. Alternatively, devaluation

may augment inflation by speeding the process of adjusting nominal wages and thus domestic prices.[4] Although this latter explanation may be more relevant to countries with formal wage-indexing systems, it may also apply to countries with very high inflation rates, in which public sector wage rates are often adjusted after large devaluations.

In addition to these three theories of inflation, two others more reflective of the old "cost-push" and "demand-pull" models of inflation have been advanced. One emphasizes the role of higher import prices, an important cost-push element that can increase domestic prices both directly and through its effect in raising the cost of domestically produced manufactures. The other stresses the role of higher incomes that lead to a rise in aggregate demand as a source of inflation. This view is reminiscent of more traditional demand-pull models.

This paper does not attempt to build a detailed structural model of inflation in African countries, such as that in Chhibber et al. (1989) or to undertake a formal test for the relevance of alternative inflation theories, as is done in Montiel (1988). Nevertheless, some initial conjectures can be drawn by comparing data on inflation for high- and moderate-inflation countries with movements in potential explanatory variables, such as the rate of monetary growth, the ratio of fiscal deficit to GDP, trends in import prices, and movements in composite nominal effective exchange rates, the latter being a measure of changes in national currencies vis-à-vis a set of country trading partners and trade competitors. These data, drawn from IMF (1989) and the IMF's *International Financial Statistics* data base (for nominal effective exchange rates), appear in Table 8.3. In addition, the paper reports on estimates of some reduced-form equations for the percentage change in the consumer price index in high- and lower-inflation countries as a further test of the relationship between inflation and these particular variables.

The data in Table 8.3 provide strong support for the role of monetary expansion in generating inflation. African countries with high rates of inflation have tended on average to have faster rates of monetary growth during the post-1974 period than have African countries with lower inflation rates, even though money growth was not necessarily faster in the high-inflation countries every year. During 1981–1988 the average yearly growth rate of broad money in the high-inflation countries approached 26 percent, nearly twice the rate in other African countries. This general pattern can be seen in Figure 8.1, a scatter diagram of inflation and monetary expansion for the high-inflation and other African countries throughout the 1975–1988 period. Indeed, the simple correlation between inflation and monetary expansion in these two groups of countries was 0.63. Of course, the relationship between monetary expansion and inflation may reflect other factors, such as the rate of domestic credit expansion, particularly where net foreign assets have been static or declining.

TABLE 8.3

Selected Economic Indicators for High-Inflation and Other Countries, 1975–1988

	High-inflation countries						Other countries					
	Inflation rate[a]	Money growth[b]	Fiscal deficit[c]	Net credit to government[d]	Import prices[e]	Exchange rate[f]	Inflation rate[a]	Money growth[b]	Fiscal deficit[c]	Net credit to government[d]	Import prices[e]	Exchange rate[f]
1975	30.6	37.6	9.8	11.5	12.0	n.a.	11.1	18.4	6.8	8.7	14.8	n.a.
1976	26.3	35.2	9.7	20.7	−0.7	n.a.	9.9	23.8	8.5	7.0	−1.4	n.a.
1977	30.0	34.0	8.2	32.3	9.6	−1.2	13.2	20.4	7.8	3.7	8.2	−0.3
1978	26.8	10.7	5.7	18.7	13.8	−9.2	12.3	18.1	7.3	9.8	11.9	−2.0
1979	24.4	15.4	5.0	6.8	15.6	−8.2	11.8	16.0	7.6	5.8	15.8	0.6
1980	21.9	40.2	3.6	5.6	15.7	4.7	10.6	14.0	7.3	6.6	15.5	2.2
1981	33.4	24.3	7.8	31.9	−3.7	1.1	12.3	15.7	5.4	4.4	−4.4	1.9
1982	14.5	16.1	7.7	22.7	−4.6	−1.8	10.6	18.1	8.4	8.2	−6.1	2.7
1983	31.7	19.9	8.2	33.9	−4.6	−5.8	8.1	12.7	10.0	6.9	−3.8	1.8
1984	39.4	21.2	4.8	13.7	−2.8	−6.9	9.4	16.0	6.5	6.5	−3.2	3.3
1985	15.8	27.2	4.0	8.1	−1.6	−13.2	9.3	15.1	6.8	2.5	−1.5	2.3
1986	17.9	20.8	4.9	2.1	13.5	−43.3	9.3	6.6	8.2	6.7	13.0	−7.1
1987	26.2	31.0	9.5	6.0	10.9	−59.9	6.1	9.9	7.4	5.9	10.7	−6.1
1988	37.0	45.3	9.5	18.9	6.2	−18.6	8.2	9.8	7.8	4.1	5.1	−4.6
Averages:												
1975–80	26.6	28.7	7.0	15.9	11.5	−3.5[g]	11.5	18.4	7.6	6.9	10.8	0.1[g]
1981–88	27.0	25.8	7.0	17.2	1.8	−18.5	9.2	13.0	7.5	5.6	1.3	−0.7

NOTE: n.a. = not available.

a. Percentage change in consumer prices.

b. Percentage change in broad money (M_2)

c. Central government budget deficit as a percentage of GDP.

d. Percentage change in net credit to government, relative to the broad money stock at the start of the year.

e. Percentage change in import unit values (in U.S. dollars).

f. Percentage change in nominal effective exchange rate; negative figure indicates depreciation.

g. Average for 1977–1980.

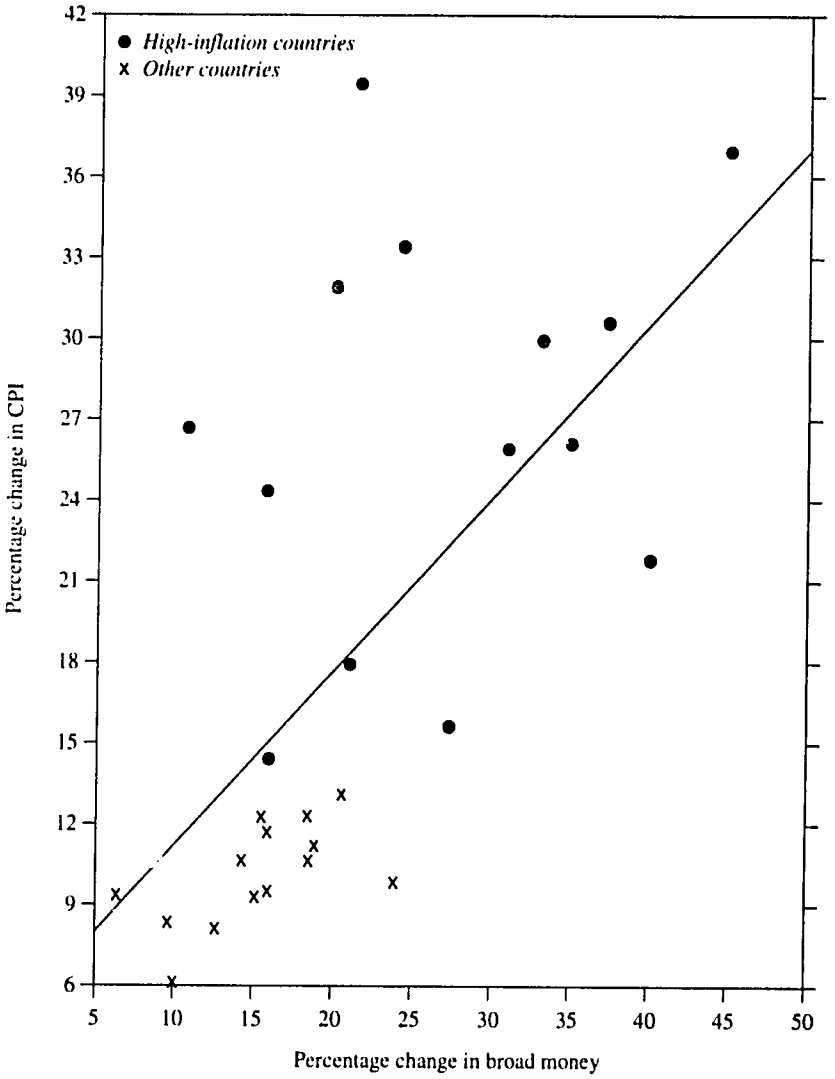

Figure 8.1. Percentage Changes in Consumer Price Index and Broad Money, 1975–1988

There does not seem to be the same close relationship between inflation and fiscal deficits per se. For example, central government budget deficits as a percentage of GDP were actually somewhat smaller in the high-inflation countries than in other African countries during most of this period. This lack of correlation between inflation rates and fiscal deficits could be because the data available reflect only central government fiscal deficits, rather than deficits for the entire public sector, for which information is not readily available. It could also be because the same budget deficit may have very different inflationary repercussions depending on its financing. For example, a budget deficit financed by external resources would have a less inflationary impact than would one financed by domestic bank borrowing. On this issue Table 8.3 indicates that the increase in net credit to the government (as a proportion of the beginning-year broad money stock) in the high-inflation countries averaged nearly three times greater than in the countries with lower inflation rates. This suggests that governments in African countries stimulated inflation by augmenting the growth of total domestic credit.

This can also be seen from a scatter diagram relating inflation rates to the growth in net credit to government (Figure 8.2). Fiscal policy, in other words, appears to have contributed to inflation in these countries but mostly by contributing to faster monetary growth. The data in Table 8.3 also provide little support for the role of imported inflation, as measured by import unit values in U.S. dollars, as an underlying source of inflation in African countries. Import unit values rose slightly faster in the high-inflation countries than in the rest, but the difference averaged less than one percentage point.

There is a strong, contemporaneous relationship between exchange rate depreciation and the rate of inflation in African countries during the 1981–1988 period, although this need not imply that the direction of causality is from depreciation to inflation. As measured by nominal effective exchange rates, the average annual rate of depreciation in the high-inflation countries was 18.5 percent and exceeded 20 percent for ten of the twelve countries in the group. By comparison, the average rate of depreciation was only 0.7 percent for the moderate-inflation countries and 0.6 percent for the subset of these countries in sub-Saharan Africa. In only two of these countries was the average rate of depreciation above 10 percent during the period, and only one (Equatorial Guinea) had an average rate of depreciation as high as that of countries in the high-inflation group.

Moreover, after excluding two years (1986 and 1987) when depreciation was unusually large in the high-inflation countries, the simple correlation of inflation with depreciations in the nominal effective exchange rate for these two groups of countries is 0.53. Thus the data are consistent with a relation between exchange rate movements and inflation in African countries, which is also in agreement with the results in Montiel (1988). This can

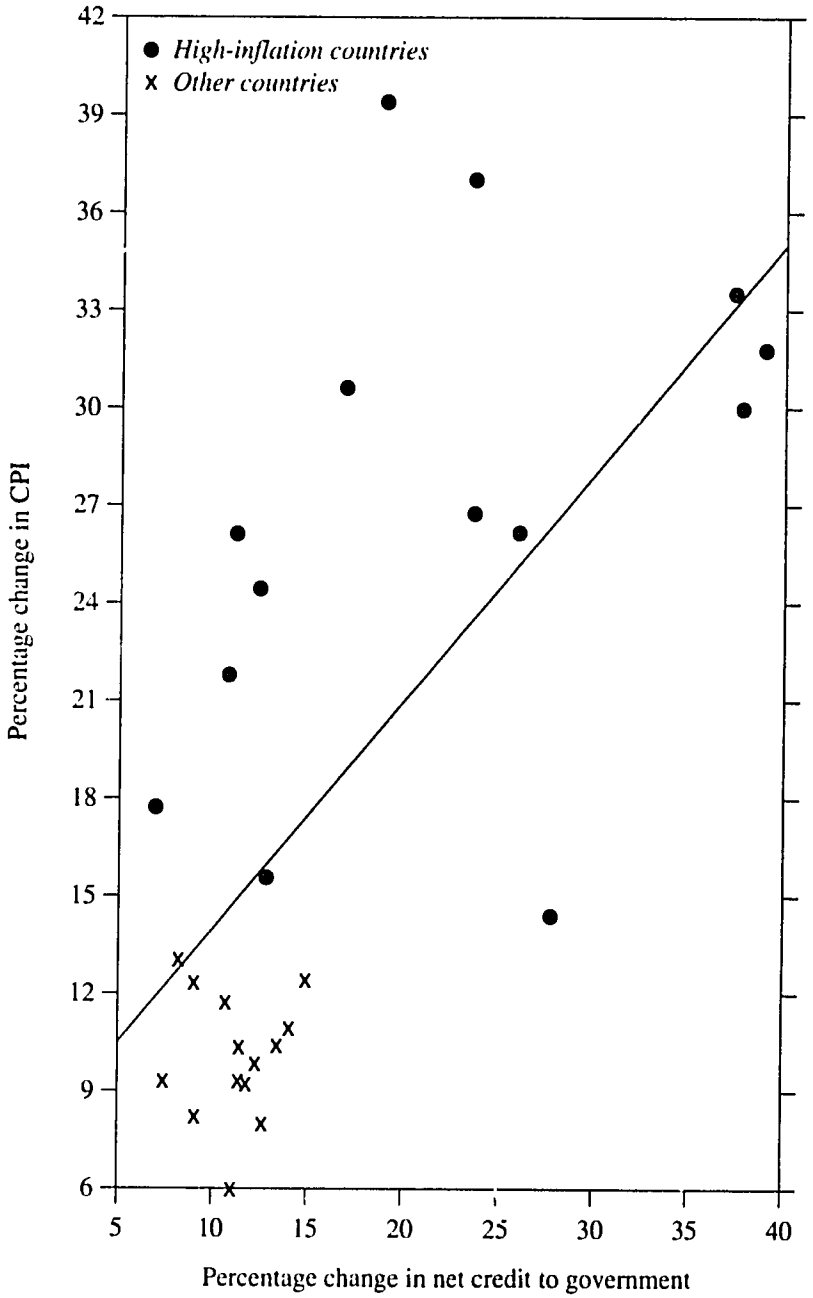

Figure 8.2. Percentage Change in Consumer Price Index and Growth in Net Credit to Government, 1975–1988

also be seen from the scatter diagram of inflation and movements in the nominal effective exchange rate for both high-inflation and other countries in Africa (Figure 8.3).[5]

Despite these observations, the precise relationship between exchange rate depreciation and inflation is complex. In many of the high-inflation countries, depreciation occurred only after several years of rapid monetary expansion, high inflation, and a decision by the government either to adjust the official exchange rate (as in Ghana, Tanzania, and Uganda in 1987 and 1988) or to allow the rate to float, either temporarily (as in Zambia) or permanently (as in Zaire). In some cases the government did so in response to the growth of widespread parallel exchange markets, which had developed in response to continuing monetary expansion and the subsequent overvaluation of the official (fixed) exchange rate. In these situations exchange rate adjustment may well have been a response to other and more fundamental sources of inflation, rather than an immediate cause.

Exchange rate adjustments themselves, however, raise the domestic prices of imported goods and thus affect the overall inflation rate. In some countries where foreign exchange is extremely scarce and most current account transactions occur on the parallel exchange market, there may even be a more direct link between the parallel exchange rate (sometimes reflecting prior monetary expansion) and the overall consumer price index. Indeed, there have been cases, such as Uganda in May–June 1987 and Mozambique in late 1988, where a depreciation of the official exchange rate in conjunction with other adjustment policies contributed to a temporary appreciation of the parallel market rate and a temporary reduction in some consumer prices. Thus more detailed analysis is needed to specify the precise role of exchange rate depreciation in generating inflation in African countries, in particular the extent to which depreciation, as part of a vicious circle involving monetary expansion and other factors, has acted as an independent cause of inflation in African countries.[6]

Current empirical research on this issue is inconclusive. Chhibber et al. (1989), in their analysis of inflation in Zimbabwe, find that the exchange rate, acting through the price of imported goods, had a positive but statistically insignificant effect on the domestic inflation rate once certain institutional relationships involving food and service prices had been taken into account. Similarly Harber (1989), in his analysis of inflation in Zambia, found monetary expansion rather than exchange rate depreciation the proximate cause of inflation during the period of its foreign exchange auction, 1985–1987. But Montiel (1988) has determined that initial exchange rate movements were an important and identifiable cause of hyperinflation in Argentina, Brazil, and Israel. In addition, London (1989) found that the exchange rate was a significant determinant of African inflation during 1980–1985 but not during 1974–1979.

Although data on wage rates and on farm incomes or producer prices

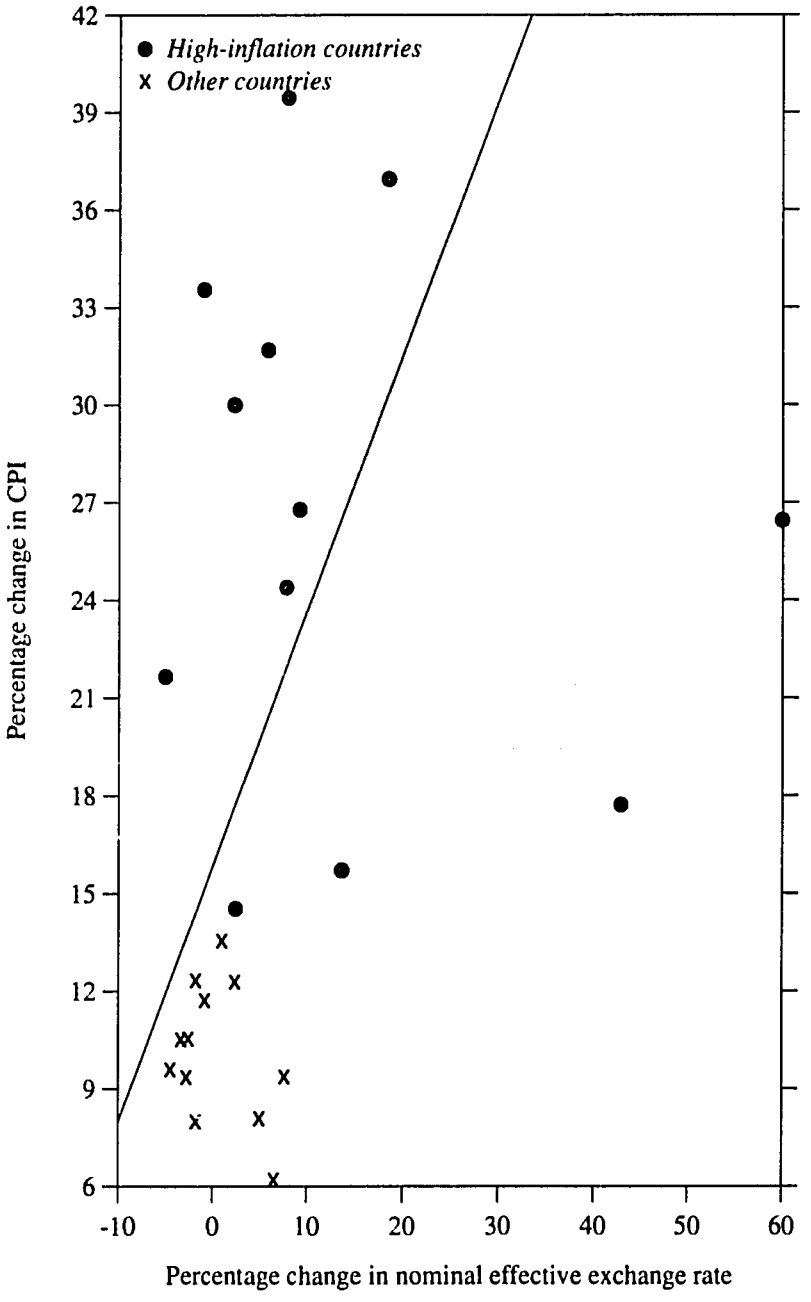

Figure 8.3. Percentage Changes in Consumer Price Index and Nominal Effective Exchange Rates, 1977–1988

are not readily available for groups of African countries, there is some evidence that wage movements have contributed to inflation in Africa, if not as initial cause then as a factor facilitating inflation in response to other developments such as exchange rate depreciation. Countries that have experienced large, discrete devaluations have often observed major subsequent increases in wage rates that have subsequently boosted aggregate demand and reinforced inflationary trends already under way. Similar effects may have occurred in countries with severe foreign exchange shortages and limited supplies of domestically manufactured goods after increases in agricultural producer prices.

In the case of Uganda, for example, after the May 1987 devaluation wage increases in the private and public enterprise sectors were especially pronounced, raising local food prices and negating the gains in real income from the across-the-board wage increases granted to civil servants. In some countries the resulting increases in consumer prices have led to substantial appreciation in the real effective exchange rate, undermining competitiveness and creating pressure for further exchange rate depreciations. Indeed, the inability to restrain wage increases after a devaluation has sometimes led to a vicious circle of devaluation and wage adjustments whose ultimate effect has been a continuing inflationary spiral, much as in countries with formal indexation systems.

As a further test of the effects of different factors on the inflation rate in African countries, several reduced-form equations were estimated relating the weighted average percentage changes in the consumer price indices for high- and lower-inflation African countries to each of the four main variables discussed above, using various lag specifications. The equations took the following forms:

$$\Delta CPI = a_0 + a_1\Delta M2 + a_2 DEF/GDP + a_3\Delta IMP.PR + a_4\Delta NEER \quad (1)$$

$$\Delta CPI = a_0 + a_1\Delta M2 + a_2 DEF/GDP + a_3\Delta NEER \quad (2)$$

$$\Delta CPI = a_0 + a_1\Delta M2 + a_2 DEF/GDP + a_3\,(\Delta IMP.PR - \Delta NEER) \quad (3)$$

where ΔCPI is the percentage change in the annual average level of the consumer price index, $\Delta M2$ is the percentage change in the average broad money stock during a year, DEF/GDP is the ratio to GDP of the central government's overall budget deficit (with deficits recorded as positive numbers), $\Delta IMP.PR$ is the percentage change in the average annual unit value for imports (measured in U.S. dollars), and $\Delta NEER$ is the percentage change in the average annual nominal effective exchange rate.

In equation 3, the last two variables were combined to impose the condition that the coefficients a_3 and a_4 of equation 1 were equal. This would imply that the main effect of exchange rate movements on domestic prices was through its impact on the domestic price of imported goods and services. To estimate the equations, weighted averages of individual coun-

try observations for twelve high-inflation and thirty-five more moderate-inflation African countries were constructed, with the weights representing the relative size (in U.S. dollars) of each country's GDP, averaged over the preceding three years. Two observations for each variable were calculated and used in the sample set for each year—one for the average of high-inflation countries and one for the average of the more moderate-inflation countries. Because data for nominal effective exchange rates were available only for the period 1977–1988 and it was desirable to test for the effects of both current period and once-lagged explanatory variables, the equations were estimated with twenty-two observations, two for each year from 1978 to 1988. As the coefficients on $\Delta MIP.PR$ had uniformly low t-statistics, the final estimations involved only variants of equations 2 and 3.

The principal equations, using contemporaneous values for the rate of broad money growth and the fiscal deficit and either current or lagged values of the percentage change in import unit values and in nominal effective exchange rates, are shown in Table 8.4. Because of the heavy weight attributed to Nigeria and the substantial fluctuation in its year-to-year inflation rates, equations were estimated with and without observations for Nigeria. As the results for both sets of equations were quite similar, only equations for data including Nigeria are reported in the table.

The regressions provide considerable support for the importance of monetary growth ($\Delta M2$) as a determinant of inflation in Africa, the lagged value of $\Delta M2$ having a statistically significant coefficient in the range of about 0.8. These results suggest that a 1-percentage-point increase in the rate of broad money growth is associated with about a 0.8-percentage-point increase in the inflation rate during the following year. The equations revealed that the contemporaneous change in the nominal effective exchange rate was also significant in explaining movements in the inflation rate, the coefficient being about −0.4.[7] This result was similar to the finding in London (1989), where the coefficient on the exchange rate variable was 0.51 for the period 1980–1985. Neither the ratio of the fiscal deficit to GDP nor the percentage change in import prices in U.S. dollars was significantly related to changes in inflation. Moreover, combining the import price change and nominal effective exchange rate into a single variable yielded poorer results than the use of the nominal effective exchange rate variable by itself. Overall these results are broadly consistent with the relationships observed from the simple correlations discussed above.

Impact of Inflation on the Financial Sector in African Countries

Research on the effects of inflation on the financial sectors of African countries has been very limited, and only a few general conjectures about these effects can be offered in this paper. Most of these are drawn from

TABLE 8.4

Reduced-Form Inflation Regressions, 1977–1988

Constant	$\Delta M2$	$\Delta M2_{-1}$	DEF/GDP	DEF/GDP_{-1}	$NEER$	$(IMPPR-NEER)$	$(IMPPR-NEER)_{-1}$	R^2	S.E.E.
1. −2.059	0.605		−0.935			0.248		.351	11.31
(−.16)	(1.96)		(−.59)			(1.75)			
2. −2.568		0.830		−0.598			0.167	.292	13.41
(−.16)		(2.17)		(−.34)			(1.14)		
3. −8.354		0.840		−1.096		0.293		.400	12.35
(−.55)		(2.42)		(−.66)		(2.19)			
4. −0.709	0.553		−0.845		−0.370			.429	12.04
(−.06)	(1.91)		(−.57)		(−2.44)				
5. −7.665		0.785		−1.149	−0.409			.478	11.51
(−.55)		(2.42)		(−.75)	(−2.87)				

NOTE: Dependent variable is the weighted mean percentage change in the consumer price indices for high-inflation and more moderate-inflation African countries, each aggregated into a single group, yielding two observations per calendar year. Figures in the table are coefficient estimates; numbers in parentheses are estimated t-statistics.

experience in Uganda, Zambia, and other countries in eastern Africa and may not be generalizable to other countries. More systematic research regarding these conjectures is therefore desirable. Nevertheless, these observations may be more broadly applicable insofar as they result from important rigidities in the financial sectors of African countries, in particular the reluctance of many African countries to set or adjust nominal interest rates so that real rates (nominal rates less the currently expected rate of inflation) are positive.

Certainly *one* effect of inflation on the financial systems of African countries is a tendency for residents to economize on the use of money. This can be seen in Table 8.5, which reports a number of monetary indicators for both high-inflation and other African countries. As a whole, the velocity of money in the high-inflation countries is significantly higher than that in the other African countries, the average for the former group being one and one-half times that of the latter during 1981–1988.

A *second* consequence of inflation that arises in the context of negative real interest rates is a persistent excess demand for credit from the private sector in many African countries, particularly for short-term ventures. This process has been aided by the prevalence of overdraft financing in many countries, an inheritance from British banking practice, as the normal format for business credit and by the reluctance of commercial banks to make medium- or long-term commercial loans. Where the expected inflation rate exceeds nominal interest rates, borrowing for certain types of private ventures becomes very attractive, particularly where scarcities of consumer and other goods allow private firms to revise product prices frequently.

These same forces encourage consumers to spend, so as to avoid future price increases. Accordingly, private savings are discouraged, and firms may prefer to stockpile consumer goods or other real assets in place of financial assets as a way of maintaining financial reserves. Where inflation is virulent and real interest rates are highly negative, the share of time and savings deposits (that is, quasi money) in broad money may also decrease, as private agents economize in general on their use of cash balances. Table 8.5 provides some support for this during 1984–1987, although for the entire 1976–1987 period the percentage of quasi money in broad money was fairly similar in high-inflation and other African countries, once data for Nigeria (a high-savings country) are excluded.[8]

A *third* consequence of inflation for the financial sector is a greater interest, among both borrowers and lenders, in short-term activities. Given the uncertainties arising from inflation, borrowers are more likely to seek funding for short-term ventures offering relatively secure returns, thereby avoiding riskier propositions that may require more time (and greater short-term financial outlays) to turn profitable. In countries with volatile exchange rates and high inflation, there may be a move into short-term

TABLE 8.5

Selected Monetary Indicators for High-Inflation and Other Countries, 1975–1988

	High-inflation countries			Other countries		
	Velocity[a]	Quasi-money share[b]	Growth in real private credit[c]	Velocity[a]	Quasi-money share[b]	Growth in real private credit[c]
1975	4.44	0.23	n.a.	3.77	n.a.	n.a.
1976	4.46	0.23	97.2	3.47	0.19	n.a.
1977	4.11	0.22	28.9	3.31	0.20	67.6
1978	4.45	0.21	53.6	3.13	0.21	207.9
1979	5.09	0.22	23.8	3.10	0.21	18.7
1980	4.43	0.23	56.4	3.17	0.22	−4.9
1981	4.41	0.22	63.8	3.11	0.23	183.8
1982	4.42	0.25	113.7	2.99	0.23	110.8
1983	4.46	0.24	−59.8	2.99	0.23	54.5
1984	4.23	0.23	107.4	2.84	0.24	−24.7
1985	4.05	0.24	501.1	2.73	0.25	−21.7
1986	3.96	0.22	105.8	2.62	0.25	−13.5
1987	4.51	0.24	12.9	2.59	0.27	37.8
1988	4.02	n.a.	n.a.	2.58	n.a.	n.a.
Averages: 1975–80	4.50	0.22	52.0[d]	3.33	0.21	72.3[e]
1981–88	4.26	0.23[f]	120.7[f]	2.81	0.24[f]	46.7[f]

NOTE: Data represent averages for country groups weighted by a three-year moving average of country GDP in U.S. dollars.
n.a. = not available.

a. Ratio of GDP to broad money (M2).

b. Quasi money (time and savings deposits) as a percentage of broad money (M2); data exclude Nigeria.

c. Percentage change in end-of-year private sector credit divided by percentage change in end-of-year consumer price index.

d. Average for 1976–80.

e. Average for 1977–80.

f. Average for 1981–88.

SOURCES: IMF, *International Financial Statistics*; and IMF 1989.

speculative activities, such as the stockpiling of imported goods or of agricultural commodities in anticipation of future price increases. This, for example, was the case in Uganda during 1987 and the first half of 1988, when rapid inflation and the extreme scarcity of consumer goods enabled merchants to earn large profits on sales of imported consumer durables, while coffee brokers accumulated large loan balances during certain times of the year by holding coffee in anticipation of subsequent increases in official producer prices.

As regards lenders, commercial banks can earn significant nominal profits on short-term lending operations, even where real interest rates are highly negative, by confining themselves to relatively safe activities, such as normal trade finance and seasonal financing of large agricultural concerns. The reason is that governments in most African countries fix interest rates and provide commercial banks with significant spreads between deposit and lending rates. The availability of large nominal profits on short-term lending helps to explain the steady growth in the volume of private sector credit in countries with high inflation rates and interest rates that are substantially negative in real terms. Indeed, as Table 8.5 indicates, during 1981–1988 high-inflation African countries on average exhibited somewhat faster rates of growth in credit to the private sector, after allowance for inflation, than did countries with lower inflation rates.

A *fourth* consequence of inflation for the financial sector has been a reduction in loan losses, particularly as regards commercial lending. Where inflation is marked, borrowers can repay old debts in much cheapened currency, thereby reducing the real cost of debt service. Defaults and loan losses therefore decrease. This, in conjunction with guaranteed spreads between the costs of obtaining and providing funds, provides further impetus for short-term commercial borrowing, thereby raising the growth rate of credit to the private sector. In Uganda, for example, rapid inflation during the mid-1980s largely eliminated loan losses as a serious concern for the commercial banks by early 1988, thereby increasing the willingness of the banks to meet the commercial sector's demand for credit. At the same time inflation has probably not strengthened the balance sheets of commercial banks, because the real value of their assets as well as their liabilities has eroded.

Policy Responses to Inflation and Their Effects on the Financial Sector

During the past decade a number of African countries have attempted, with varying success, to reduce inflation through the implementation of economic adjustment programs. There is evidence that countries making strong efforts at implementing these programs have in fact achieved significant reductions in their inflation rates.

Reducing inflation is an important aspect of economic stabilization that can benefit national economies in a variety of ways. Financial systems in particular stand to gain, especially where (as in Africa) institutional rigidities make it difficult for interest rates to reflect the real cost of capital, thereby subsidizing borrowing and discouraging financial savings. In the transition to a more moderate inflationary environment, however, the financial sector of a country may experience some difficulties, particularly as borrowers adjust to a new economic environment in which real interest rates are less highly negative and fiscal and monetary policies are made more consistent with the country's available financing. Some of these problems are worth mentioning here, although it should be stressed that these are transitional costs rather than reasons for not undertaking economic stabilization.

First, banking sector activity is likely to decrease, particularly where national authorities use outright ceilings on the growth of private sector, as well as public sector, credit as the instrument for achieving their monetary and credit objectives. This, in turn, may reduce banking sector profits, at least in nominal terms. At the same time the reduction in total loan volume may be accompanied by an improvement in total banking assets, as the volume of loans profitable only at highly negative real interest rates declines. There may also be an increase in real profits from the decline in inflation.

Second, lower inflation rates may contribute to higher loan losses if the slowdown in inflation is accompanied by recession and greater business difficulties. Accordingly, banks may be less willing to extend credit in some cases and may need to retrench so as to strengthen their capital base, particularly where stronger bank supervision is part of an adjustment program. In some situations the adverse effects on private sector activity may be such as to make a significant percentage of private sector loans nonperforming, thereby jeopardizing the soundness of major elements of the commercial banking sector. This, in turn, may necessitate government financial support to individual banks. The requisite government expenditure needed for this support must then be taken into account when developing fiscal policy and setting goals for credit to the public sector.

On the positive side, with less inflation banks may be more willing to lend for longer-term activities, as the uncertainty and financial risks attached to them decrease in relation to the returns from shorter-term ventures. It may therefore become easier for borrowers to finance longer-term capital investments offering a greater chance of improving output and productivity at their enterprises. In short, there may be less lending overall but more funds available for investment, particularly for projects that stand a chance to increase national output and strengthen the balance of payments over time.

Where higher interest rates accompany the economic adjustment process, a variety of consequences may follow, some of which may appear unfavorable to the financial sector as the economy adapts to a more realistic set of price incentives. Higher nominal interest rates, however, that raise the real rates on deposits and lending will reduce the incentives for speculative short-term borrowing while increasing (at least relatively) the incentives for financial saving. The quality of loan portfolios should improve as a result, and savings deposits may increase. At the same time, however, the volume of private sector loan applications is likely to decrease, although total bank lending could increase if the higher interest rates generate a rise in loanable funds and enable banks to approve a much larger percentage of the remaining loan applications. Higher interest rates may also impose financial losses on firms, particularly those selling commodities whose prices are fixed by government order. Public enterprises, which are common in many African countries, are particularly likely to bear the brunt of higher interest rates (although they were also benefiting from the previous regime of more negative real interest rates), and the resulting losses (or increases in losses) may translate into higher budgetary subsidies and greater government demands for banking credit.

Few African countries have experimented with eliminating interest rate ceilings and reducing reserve requirements.[9] The experience of Argentina and Chile with these types of reforms suggests, however, that they carry risks if not implemented in the context of an effective bank supervision system. Particularly where financial markets are thin and there is a perception that governments will intervene to prevent bank failures, interest rate liberalization can encourage commercial banks to increase the riskiness of their loan portfolios, especially where a sharp rise in interest rates crowds out loan applications for safer but lower-yielding investment projects (Le Fort 1989). Adequate bank supervision is needed to counteract this tendency. In many African countries thorough supervision is hard to maintain, but greater effort in this area is essential if the reforms are to have much chance of success.

The rise in real interest rates should generate some increase in financial savings. In practice, however, the impact may be small or uncertain. Research to date on savings behavior in developing countries has found little evidence to support a strong interest rate sensitivity of aggregate private savings.[10] This may reflect a variety of factors, including a lack of suitable savings instruments and the availability of more attractive alternatives, such as foreign assets or investments in nonfinancial assets, to agents with resources available for savings. Accordingly, it may be optimistic to hope that increases in interest rates, particularly small increases that leave real rates highly negative, can generate significant increases in private savings. Thus most of the benefits from higher interest rates are likely to

come from their impact on financial savings and bank lending activity and from improvements in the efficiency of investment.

Summary and Conclusions

During the past fifteen years African countries have experienced substantial inflation. During the 1980s in particular the inflation rate has averaged about 17 percent a year for African countries and 20 percent for the sub-Saharan countries. A small group of about twelve African countries have experienced very high inflation rates, averaging about 27 percent a year, the average for the others being about 9–10 percent during the 1980s.

A variety of factors have contributed to inflation in African countries, including the effect of the first and second oil shocks and, to a lesser extent, rising prices of imported consumer and intermediate goods from the industrial countries (particularly during the 1970s and in 1986–1988). Domestic monetary expansion, however, has played a very important role. There is clear evidence that rates of monetary expansion have been substantially higher on average in high-inflation African countries than in more moderate-inflation countries, monetary growth averaging about 26 percent a year in the former and 13 percent in the latter during the 1981–1988 period. Exchange rate depreciation has also been considerably greater in the high-inflation countries, although it is hard to determine the direction of causality between exchange rate movements and the inflation rate. By comparison, fiscal deficits in the two groups of countries have been roughly similar. Credit to government has increased considerably faster, however, in the high-inflation countries.

Inflation has had a number of adverse consequences for the financial sectors of African countries, effects magnified by structural rigidities. Because nominal interest rates have generally been kept low, real interest rates have usually been negative, sometimes highly so in countries with very high rates of inflation. This has encouraged borrowing for short-term trade activities and has discouraged savings. Lending for longer-term investments has also been discouraged, and in high-inflation countries there has been evidence of borrowing for short-term speculative activities. At the same time loan losses have declined, which may have encouraged the total volume of bank lending.

Domestic stabilization policies to reduce the rate of inflation are likely to affect the financial sectors of these countries in a variety of ways. Lower inflation may increase the demand for investment and to that extent the demand for credit. It may also make banks more willing to engage in longer-term lending, thereby facilitating investment projects yielding higher benefits in the long run. In the short run greater fiscal and monetary restraint may also reduce the total volume of bank lending, thereby

reducing nominal bank profits, and, by slowing private sector activity, contribute to greater loan losses.

Despite the possible adverse consequences in the short run, African countries stand to benefit in a variety of ways from reducing inflation. Lower inflation rates contribute strongly to an improved economic climate that fosters growth through greater stability. A low-inflation environment makes it easier for firms to plan and implement new investment projects by reducing uncertainty and encourages financial savings by providing positive real returns at more moderate nominal interest rates. Lower inflation rates also reduce the costs associated with the need to make frequent price adjustments and to take precautions against future inflation. The quality of the banking sector's loan portfolio should also improve, as less inflation makes more long-term investments viable. Accordingly, policies to lower inflation are essential for African countries to strengthen their financial sectors and achieve a healthier economic environment.

-229'

9

C. S. Kimei

The Impact of Monetary and Fiscal Policies on the Financial System in Tanzania

The growth strategies adopted by African countries in the postindependence period may broadly be categorized into two groups: (1) strategies of a socialist orientation aimed basically at redressing income distribution through enhanced public ownership of the commanding heights of the economy; and (2) strategies along the capitalist path, marked by limited government interference with markets and gradual growth of a mixed economy with private sector dominance. The nature of macroeconomic policies and instruments used to achieve them under the two strategies has been both practically and conceptually different. In particular, Tanzania and other countries that embarked on a socialist path had recourse to measures that entailed a considerable degree of direct regulation of the markets for land, labor, money (including capital), and goods. Countries that followed the traditional mixed economy path continued to pursue policies through indirect monetary and fiscal instruments, applied to influence decentralized decision making by economic units through the markets. This divergence in the approaches to economic policy making suggests that the impact and, indeed, the effectiveness of monetary and fiscal policies on the

economy, and the financial system in particular, will be radically different in the two groups of countries.

The objective of this paper is to evaluate the impact of monetary and fiscal policies on the financial system drawing on Tanzania's experience. I start with a brief excursus on a simple theory of financial growth in a regulated or restricted, as opposed to a liberalized or unrestricted, economy. Further, I give a brief review of Tanzania's financial system and an evaluation of its performance during 1980–1987 in terms of growth of total financial assets and its major components. The third section dwells on the weaknesses in central banking and conduct of monetary policies. Weaknesses in the financial institutions (other than the central bank), with particular attention to the experience of the National Bank of Commerce (NBC), are discussed in the fourth section of the paper. The last part of the paper presents an evaluation of the causes of the observed financial trends and implicitly presents a case for financial reform.

A Caricature of the Theory of Financial Growth in a Regulated Economy

In the economic literature there is now a consensus that the growth of a sound, well-integrated infrastructure of financial institutions, instruments, and interest rates is a necessary prerequisite for sustainable economic development (Goldsmith 1969, McKinnon 1973). The financial system has two broad objectives. The first is the provision of payments facilities—a responsibility that rests with the monetary system, comprising the note- and currency-issuing authority (or the central bank) and the intermediaries that provide checking accounts (the commercial banks). The second broad objective, which is performed by the financial system as a whole, is that of intermediation in the saving-investment process, by providing savers (surplus units) and investors (deficit units) with financial instruments that have characteristics suited to their diverse saving motives. To meet the latter objective, the financial system must in the course of time and development of the real economy widen, lengthen, and deepen.[1]

The widening of the financial system is measured by the number of actors in it, including all savers, investors, and financial intermediaries. Financial lengthening is characterized by the number of different financial instruments traded in the market, including, for instance, currency, bank deposits of all kinds, insurance and pension claims, corporate bonds and shares, government short- and long-term securities, mortgage certificates, and loans of various maturities given by financial institutions. Apparently, widening and lengthening are inseparable since the more diversified the financial asset menu, the more appealing it will be to the savers and investors with different preferences for the attributes of liquidity, yield, risk, divisibility, and convenience combined with different weights in specific

financial instruments. The overall outcome of financial lengthening or widening is deepening in finance. Financial deepening is the growth of the relative share of financial assets in total wealth, and it is generally taken as an aggregate measure of financial development.

The growth of the share of wealth held in the form of financial assets is important for two main reasons. First, it reflects an increase in the portion of aggregate savings that is allocated to investors through financial intermediaries (and thus independent of the savings units) and in this respect indicates an improvement in the efficiency of resource allocation. Second, the more short- and long-term financing is accommodated by the financial system, the more effectively credit policy can be used to influence economic activity.

In choosing a strategy for financial growth, countries are faced with two extreme alternatives: (1) rely on the inherent strength and dynamic efficiency of competitive markets and unrestricted financial growth, or (2) centralize financial decisions and shape the financial underpinnings of the development strategy by government intervention and restricted financial growth.

The argument for allowing competitive markets in equities, bonds, and money is straightforward. Competition may, in theory, be expected to accomplish all the major targets of financial development: raising the level of savings, efficiently channeling them into investments with different degrees of yield and risk, and creating an integrated financial market.

The unrestricted financial growth hypothesis. The contestability of markets for equities and debt instruments has the following theoretical implications:

- It aids the appearance of new types of financial intermediaries that, in combination, offer an asset menu with broad selection in terms of yield, liquidity, risk, and divisibility.
- It widens and lengthens the markets in which investment opportunities compete for savings, opening the way to superior allocations of loanable funds.
- It drives interest rates to reflect more accurately both opportunities that exist for substituting investment for current consumption and consumers' time preferences. In this regard real interest rates are likely to be high in competitive markets and will display an array of interest rate spreads that will correspond to the differentials in risk premiums attached to each financial asset in the menu.
- It leads to an equalization of the returns to physical and financial assets, thereby raising the rates of return to financial savings.
- The attendant decline in the risks of yield, liquidity, and accessibility in holdings of financial assets—including money—tend to increase

monetization of the traditional subsistence sector. Moreover, the differences in rates of interest between formal and informal financial markets tend to be decreased so that a fragmented capital market becomes increasingly integrated.

- The increase in domestic returns on financial savings may reverse capital flight.

The overall outcome of the foregoing effects of contestability is an increase in the ratio of domestic financial savings to total wealth (or income). This will reduce the incentives to government to raise funds by an inflation tax. The integration of the money and the capital markets paves the way for conducting monetary policy by using traditional instruments.

Nevertheless, unrestricted financial growth is not automatically realized by the government's doing nothing and pursuing a laissez-faire policy. If the starting point is, as it was in Tanzania at independence, an open dependent economy, without a national central bank but with financial operations mainly in the hands of foreign commercial banks, then some active government policy will be necessary to form the institutions and instruments of monetary policy and to ensure the existence of domestic competition within the financial sector. Second, the lack of incentives, information, and experience on the part of the potential domestic investors militates against a rapid spontaneous growth of financial markets. In this connection, the process of learning and assimilating new values and attitudes requires a high degree of political patience.

Restricted financial growth. In a restricted financial regime the converse of what happens in the competitive regime will obtain to a degree determined by the extent of regulations. In most cases the main reason for introducing regulations into the markets has probably been the mistrust of the market in allocating resources. This motivation is typically accompanied by the argument that markets in the less-developed countries are imperfect and by attempts to keep the cost of financing the public sector deficits as low as possible.

Restrictions on financial prices and entry and exit into the financial system have had the effect of limiting financial widening, lengthening, and deepening.

Tanzania's Financial System

Tanzania's financial structure is fairly simple. The central bank (the Bank of Tanzania—BOT) and all other banks and financial institutions (except the Diamond Jubilee Investment Trust—DJIT) are publicly owned. From 1967 until very recently, 1984, the National Bank of Commerce (NBC) was the only commercial bank chartered to operate in mainland Tanzania. Over the

period the NBC managed to spread its branch network—comprising 166 branches and 231 agencies—to several regions and districts, including one branch in Zanzibar. From 1984 the Tanzanian Rural Development Bank (TRDB) was given a mandate to broaden its business beyond the scope of its charter, to carry on commercial banking business in addition to its development banking business. The People's Bank of Zanzibar (PBZ) has been performing some central bank functions (with the exception of currency issuing) as well as the commercial banking operations to all parties but has limited its business to the islands only.

Long- and medium-term development finance is provided by several institutions. Several of these banks have a particular sectoral focus, as is evident in the following descriptions. The *Tanzania Investment Bank (TIB)* is for industry and large-scale agriculture. The sources of funds of this institution are loans from the central government and foreign sources (including multilateral institutions—the World Bank, the African Development Bank, and so on). The TIB has not mobilized local resources by accepting public deposits. The *Tanzania Housing Bank (THB)* provides medium- and long-term loans for residential and commercial housing construction. The main sources of funds for the THB are loans from government and foreign sources; public deposits, including saving and time deposit accounts (but not demand deposits); and the Workers and Farmers Housing Development Fund, a special fund to which employers contribute for the purpose of financing housing for low-income employees at subsidized rates. The *Tanganyika Development Finance Company Limited (TDFL)* is jointly owned by the government of Tanzania, the Deustche Financierings fur Beteiligungen Entwicklungslandern GmbH (DEG), and the Nederlandse Financierings Maatschappij Voor Ontwikkelingslanden N.V. Corporation. The institution operates more or less like the TIB—granting loans to all sectors of the economy, except that its lending is biased toward the private sector. The funds deployed by the TDFL originate largely from external sources.

The *Tanganyika Post Office Savings Bank (POSB)* is a savings bank, accepting savings deposits at post office counters all over the country and investing them almost entirely in government paper. The *National Provident Fund (NPF)* is a social security fund, managing all pension contributions from workers and employers. It invests a large portion of its funds in government stocks, while the remainder is lent out on a long-term basis for development projects. The *National Insurance Corporation (NIC)* is a government-owned insurance company having a formal monopoly of the insurance industry in Tanzania. The NIC conducts both general and life insurance business. It also manages, on behalf of the government, the Parastatal Pension Fund (PPF). The NIC is aided by a network of private insurance agencies and brokers, together with the publicly owned State Insurance.

Tanzania's Recent Financial Growth

The performance of Tanzania's financial system in the mobilization and deployment of resources in the period 1980–1987 is summarized in Table 9.1. The rather poor performance that is pictured in the table is not, however, without precedent. A previous, more extensive analysis of Tanzania's financial performance for the period 1950–1980 shows that the period 1950–1965 was one of growth in finance while 1967–1980 was marked by financial retrogression (Kimei 1986). Therefore, the poor performance of the 1980s may be viewed as having begun in 1967. Nonetheless, the performance of the financial sector in Tanzania during the 1970s was relatively positive when viewed against Table 9.1. For this purpose, an examination of rows 1 through 4 in Table 9.2 is warranted. They show an increasing percentage of gross domestic product (GDP) that is accounted for by each of the monetary indicators for the period 1970 to 1981–1983—and their decline thereafter.

The financial survey of Table 9.1 includes assets and liabilities of all financial institutions. As is evident from the description of the financial institutions in the country in the previous section, the financial system remained more or less intact over the period 1973–1988, with the exception of the reconstitution of the rural development financing institution (the TRDB) into the Commercial and Rural Development Bank (CRDB) in 1984. Thus, over the period of fifteen years or so, the financial system did not change its degree of institutional specialization. Even the financial instruments available in the economy remained static over the period.

The overall performance of the financial system is assessed by the trends in the ratios of the total financial assets and the major types of financial assets to national wealth (proxied by GDP). Table 9.1 clearly indicates a marked decline in the ratio of total financial assets to GDP from about 59 percent in 1980 to 36 percent in 1987. The ratio of monetary assets, defined to include broad money (M2) and assets of the savings bank (the POSB), to GDP declined from 48 percent in 1980 to 34 percent in 1987. Nonmonetary financial assets as a percentage of GDP were reduced from 11 percent to a mere 2 percent over the same period. These trends suggest that both the monetary system—commercial banks (including the central bank)—and the nonmonetary system retrogressed in those eight years. For the monetary system this was a reversal of the trend registered in the 1970s, when there was some growth that reflected an increase in money demand on account of relatively low interest rates and inflation rates (see Kimei 1986). The fall in the assets of the nonmonetary financial sector in relation to wealth in 1980–1987 was a dramatic worsening of a period of extended stagnation: between 1965 and 1980 nonmonetary assets varied between 8 and 11 percent.[2]

Weaknesses of the Existing System of Financial Institutions

Weaknesses of the Bank of Tanzania (BOT). The main function of central banks is to conduct monetary policy, of which the major objective is to maintain domestic and external monetary stability. By any standards the BOT has not successfully performed this fundamental task. Inflation began soaring (or, as others put it, skyrocketing) in 1979. By 1987–1988, the inflation rate appeared to have at least "stabilized," though at a high annual rate of about 30 percent (see Figure 9.1 and Table 9.3). The external balance-of-payments position has been in chaos, with huge current account deficits (excluding government transfers) reaching up to about 200 percent of total export proceeds in 1987.

For developing countries in general, and Tanzania in particular, I have deemed the prerequisites for effective control of monetary expansion to be (Kimei 1986, chap. 8)

- a tight fiscal stance that limits the budget deficit to a low level
- proper coordination of monetary, fiscal, and exchange rate policies
- binding restrictions on the accessibility of the financial system to the central bank—that is, the central bank should strictly be a lender of last rather than of first resort
- effective control over the liquidity level of the financial system
- a viable and efficient financial system that encourages deposit mobilization

Although the original BOT Act had given the central bank effective power to limit government borrowings from it—by stipulating a statutory maximum of one-sixth of annual budgeted revenue—government borrowing from all banks was beyond control, as the government had recourse to the NBC whenever the BOT limit was approached. The amended BOT Act (1978) is much less restrictive on the central bank's ability to limit government bank borrowing. It sets an annual limit of one-sixth of budgeted revenue on central bank lending to government for recurrent needs but leaves more or less open the central bank's purchase of government debt for capital or development purposes. The implication of this laxity in the amended BOT statute is that the BOT may—given the limited autonomy it has over the treasury—be forced to accommodate the government at a rate that might prohibit the attainment of desired monetary objectives.

More important perhaps is the silence of the act with respect to penalties that would be incurred by BOT management in the event of failing to comply with the statutory limits on its lending to government. There is a corresponding silence regarding the consequences of BOT

TABLE 9.1

Survey of Tanzanian Financial Institutions, 1980–1987 (millions of shillings)

	1980	1981	1982	1983	1984	1985	1986	1987
Assets								
Foreign assets (net)	1,201.1	855.2	763.5	1,881.9	−7,590.2	−10,786.8	−12,883.9	−19,937.4
Monetary survey (net)	1,199.6	853.7	761.7	1,879.9	−7,592.5	−10,789.3	−12,886.7	−19,940.7
Nonmonetary financial institutions (net)—NMFI	1.5	1.5	1.6	2.0	2.3	2.5	2.8	3.3
Domestic credit (net)	20,762.5	25,450.7	31,056.5	34,433.4	40,999.9	53,956.1	64,839.0	92,131.2
Claims on government (net)	11,661.8	14,810.2	18,599.9	21,894.7	25,838.1	33,908.9	34,452.9	34,301.2
Monetary survey (net)	10,899.0	13,924.2	17,537.1	20,659.1	24,459.0	32,278.9	32,555.8	33,454.5
NMFI (net)	762.8	885.8	1,062.8	1,235.6	1,379.1	1,630.0	1,897.1	846.7
Claims on nongovernment and private	9,100.7	10,620.5	12,456.6	12,538.7	15,161.8	20,047.2	30,386.1	57,830.0
Monetary survey (net)	7,346.4	8,482.3	9,537.3	10,642.8	12,922.2	17,678.8	27,735.1	55,042.5
NMFI (net)	1,754.3	2,138.2	2,919.3	1,895.9	2,239.6	2,368.4	2,651.0	2,787.5
Total assets	21,963.6	26,285.9	31,820.0	36,315.3	33,409.7	43,169.3	51,955.1	72,193.8

Liabilities	21,963.6	26,285.9	31,820.0	36,315.3	33,409.7	43,169.3	51,955.1	72,193.8
Monetary liabilities	13,112.9	15,110.2	17,986.8	20,207.0	20,124.7	24,862.5	35,186.0	46,821.8
Money (MS)	13,345.9	15,401.2	18,323.2	20,564.3	20,537.1	25,270.2	35,809.5	47,130.6
Less: reserves (NMFI)	233.0	291.0	336.4	357.3	412.4	407.7	623.5	308.8
Quasi-monetary liabilities	4,898.7	6,097.2	7,263.9	9,605.6	10,876.4	15,078.6	16,315.4	21,235.8
Quasi-money (MS)	4,173.9	5,293.5	6,405.5	8,563.1	9,681.0	13,700.8	14,543.9	19,312.3
Subtotal (broad money)—M2	17,519.8	20,694.7	24,728.7	29,127.4	30,218.1	38,971.0	50,353.4	66,442.9
Time, saving, F/currency deposits (NMFI)	724.8	803.7	858.4	1,042.5	1,195.4	1,377.8	1,771.5	1,923.5
Subtotal (broad money)—M3	18,011.6	21,207.4	25,250.7	29,812.6	31,001.1	39,941.1	51,501.4	68,057.6
Long-term foreign liabilities	288.7	423.0	452.9	509.8	832.3	794.1	1,524.6	1,803.7
NMFI	288.7	423.0	452.9	509.8	832.3	794.1	1,524.6	1,803.7
Government lending funds	111.2	109.0	113.8	88.8	119.3	68.8	67.2	64.3
NMFI	111.2	109.0	113.8	88.8	119.3	68.8	67.2	64.3
Insurance reserve funds	885.6	1,221.2	1,670.6	2,100.2	2,731.9	3,284.8	4,154.9	5,200.0
Other items (net)	2,666.5	3,325.3	4,332.0	3,803.9	−1,274.9	−919.5	−5,293.0	−2,931.8
Monetary survey	1,925.2	2,565.7	3,107.4	4,054.4	−429.4	197.4	−2,949.2	2,113.4
NMFI	741.3	759.6	1,224.6	−250.5	−845.5	−1,116.9	−2,343.8	−5,045.2
Memorandum items								
GDP at market prices	37,454.0	43,906.0	52,546.0	62,608.0	78,143.0	108,083.0	143,034.0	198,101.0
Assets/liabilities as ratios of GDP								
Total liquid assets/liabilities	58.6	59.9	60.6	58.0	42.8	39.9	36.3	36.4
Monetary assets/liabilities (M3)	48.1	48.3	48.1	47.6	39.7	37.0	36.0	34.4
Broad money (M2)	46.8	47.1	47.1	46.5	38.7	36.1	35.2	33.5
Nonmonetary financial liabilities	10.6	11.6	12.5	10.4	3.1	3.0	0.3	2.1

SOURCE: Bank of Tanzania.

TABLE 9.2
Important Monetary Indicators, 1970–1988

	1970	1973	1976	1979	1980	1981
GDP (current market prices)	9,173.0	11,490.0	21,652.0	32,317.0	37,454.0	43,906.0
Money supply, broad (M2)	2,305.7	3,698.6	6,946.7	13,806.6	17,519.8	20,694.8
Narrow money (M1)	1,765.5	2,820.3	5,331.8	10,435.4	13,345.9	15,401.2
Currency in circulation	818.4	1,198.6	2,071.3	4,055.4	5,245.4	6,616.0
Demand deposits	947.1	1,621.7	3,260.5	6,380.0	8,100.5	8,785.2
Quasi money	540.2	878.3	1,614.9	3,371.2	4,173.9	5,293.6
Time deposits	338.1	547.0	1,048.2	2,308.0	2,872.7	3,702.1
Saving deposits	202.1	331.3	566.7	1,063.2	1,301.2	1,591.5
Total commercial bank deposits	1,487.3	2,500.0	4,875.4	9,751.2	12,274.4	14,078.8
Reserve/base money	821.1	1,213.4	2,088.4	4,128.5	5,289.0	6,807.2
Currency outside banks	818.4	1,198.6	2,071.3	4,055.4	5,245.4	6,616.0
Commercial bank deposits with central bank	2.7	14.8	17.1	73.1	43.6	191.2
Memorandum items:						
As % of GDP						
Money supply, broad (M2)	25.1	32.2	32.1	42.7	46.8	47.1
Narrow money (M1)	19.2	24.5	24.6	32.3	35.6	35.1
Currency in circulation	8.9	10.4	9.6	12.5	14.0	15.1
Total commercial bank deposits	16.2	21.8	22.5	30.2	32.8	32.1
As % of narrow money:						
Currency outside banks	46.4	42.5	38.8	38.9	39.3	43.0

SOURCE: Bank of Tanzania.

failures to fulfill other statutory requirements, such as the monetary targets stipulated in the Annual Finance and Credit Plan.

In light of recent experience with increasing and sizable government budget deficits requiring bank accommodation, the control of domestic credit expansion would seem to require that statutory limits be established on government bank borrowing from both the central and the commercial banks.

Bank credit demand by the nongovernment sectors of the economy over the past two decades has been dominated by the parastatal sector. In particular, the parastatals' share of the total credit extended by the NBC rose from a mere 5.5 percent in 1967 to 72 percent in 1972 and to about 95 percent in 1984. After the adoption of a financial package associated with the Economic Recovery Program (ERP), giving emphasis to the availability of credit for productive purposes (irrespective of whether they were public or private), and subsequent imposition of ceilings on credit to marketing boards, the share of the public sector took a downward trend, reaching 85 percent in 1988. This is a clear case of public sector crowding out of the

TABLE 9.2
Continued

1982	1983	1984	1985	1986	1987	1988
52,546.0	62,608.0	78,143.0	108,083.0	143,034.0	198,101.0	257,531.0
24,728.7	29,127.4	30,218.1	38,971.0	50,353.4	66,442.9	89,809.1
18,323.2	20,564.3	20,537.1	25,270.2	35,809.5	47,130.6	65,400.9
7,988.7	8,194.2	10,472.4	12,719.0	18,309.7	24,550.8	31,702.2
10,334.5	12,370.1	10,064.7	12,551.2	17,499.8	22,579.8	33,698.7
6,405.5	8,563.1	9,681.0	13,700.8	14,543.9	19,312.3	24,408.2
4,533.5	6,183.7	6,811.0	9,815.7	9,632.7	12,704.8	14,504.7
1,872.0	2,379.4	2,870.0	3,885.1	4,911.2	6,607.5	9,903.5
16,740.0	20,933.2	19,745.7	26,252.0	32,043.7	41,892.1	58,106.9
8,217.7	8,480.0	10,902.0	13,499.2	18,403.1	26,250.5	34,062.3
7,988.7	8,194.2	10,472.4	12,719.0	18,309.7	24,550.8	31,702.2
229.0	285.8	429.6	780.2	93.4	1,699.7	2,360.1
47.1	46.5	38.7	36.1	35.2	33.5	34.9
34.9	32.8	26.3	23.4	25.0	23.8	25.4
15.2	13.1	13.4	11.8	12.8	12.4	12.3
31.9	33.4	25.3	24.3	22.4	21.1	22.6
43.6	39.8	51.0	50.3	51.1	52.1	48.5

private sector. The effects of crowding out in the case of Tanzania are modified by the following conditions:

- the practice of putting ceilings on nominal interest rates
- rationing of credit by ad hoc sociopolitical criteria

According to traditional theory, an increase in credit demand by the public sector will trigger an increase in interest rates, which in turn induces financial resource mobilization, since interest rates on savings also go up. When the interest rates on deposits are administratively fixed, however, the positive effect of crowding out on deposit mobilization is impaired. Worse still, when financial resources are rationed by ad hoc criteria rather than by profitability and implicit rates of return on projects, the resulting allocation becomes inferior in efficiency and growth maximization. Failure of financial institutions to earn the highest rates of return on loanable funds undermines their ability to pay attractive (or the highest possible) rates to savers, and this in turn hampers resource mobilization. The vicious circle of excess credit demand cum declining supply of savings

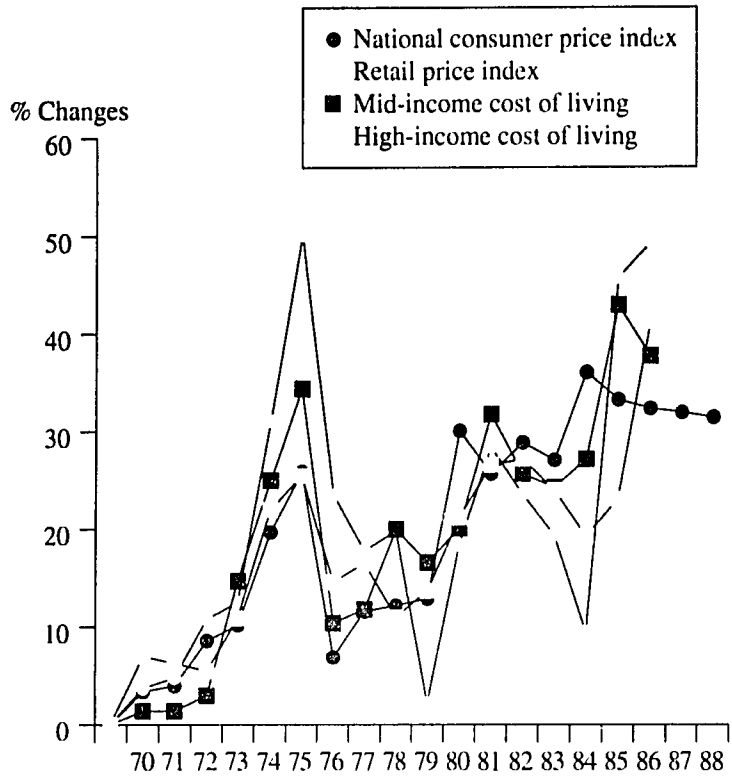

Figure 9.1. Inflation Rates by Various Price Indexes, 1970–1988

due to declining real interest and low return on investment from inefficient allocation prompts intensification of direct controls on credit allocation and further crowding out of the chicken that lays the egg (which is to say, the private sector).

Moreover, as real savings decline, the government and the expanded public sector are lured to the printing press, thereby fueling inflation, which, *ceteris paribus*, further erodes real interest rates and savings. Further, it has been argued (see the following section) that the allocation of credit by noncommercial criteria is the major cause for nonperformance of a large portion of loans in the portfolios of the financial institutions in Tanzania. This short discussion points to the important role of monetary policies in savings mobilization performance in Tanzania.

There is a direct link between monetary expansion, inflation, the balance of payments, and exchange rate movements. From the viewpoint of the monetary approach to the balance of payments, under a fixed exchange rate regime and starting from an equilibrium position, monetary expansion is offset by an equivalent amount of foreign reserve loss. With

TABLE 9.3
Inflation Trends by Various Price Indexes, 1970–1988

Period	% change in NCPI	% change in retail/PI	% change in mid-income cost of living	% change in high-income cost of living
1970	3.4	3.7	1.4	7
1971	4	4.8	1.4	6.3
1972	8.6	10.8	3	5.5
1973	10.2	12.5	14.7	10.9
1974	19.7	31.1	25	22
1975	25.9	50.1	34.4	25.5
1976	6.9	23.5	10.4	14.6
1977	11.6	17.8	11.8	16.5
1978	12.2	19.8	20	11
1979	12.9	2.2	16.6	13.7
1980	30.1	18.4	20.1	21.2
1981	25.7	28.4	31.8	26.6
1982	28.9	23.6	25.7	27.2
1983	27.1	19.4	24.3	24
1984	36.1	9.5	27.2	19.3
1985	33.3	45.8	43	23.1
1986	32.4	49.4	37.8	41.3
1987	32			
1988	31.5			

NOTE: blank cell = not available.
SOURCE: Bank of Tanzania.

exchange controls that prevent reserve deterioration by limiting imports, however, monetary expansion causes excess demand in the domestic goods market and thus inflation, which results in an overvalued exchange rate. To maintain competitiveness in the export markets and of domestic versus foreign monetary assets, the domestic currency has to be depreciated by the differential between the domestic and foreign (trading partner) inflation rates. If overvaluation of the shilling is maintained for a long period, as was the case in Tanzania during 1979–1988, domestic residents find holdings of foreign assets more attractive than domestic financial assets. This is much more the case when expectations are for a continued higher inflation at home than in trading partners and a reluctance of the authorities to adjust the interest rates and the exchange rate to equilibrium. The last three conditions guarantee windfall gains in yield at a low risk and uncertainty to holders of foreign assets. It is no wonder, therefore, that at the time of a government crackdown on economic "saboteurs," a large number of residents were found with huge amounts of foreign exchange,

which totaled over U.S.$0.5 million excluding amounts held in foreign bank accounts abroad.[3]

The impact of inflation on domestic financial savings not only encourages savings in foreign financial assets but also works through the interest rate and rates of return on financial assets in general, especially when there are administrative ceilings on interest rates. The hypothesis of financial repression, by which nominal interest rates are set below those of inflation, producing real interest rates that are below equilibrium levels, has been analyzed in great detail by various authors (McKinnon 1973, Shaw 1973, Fry 1988). Despite the ambiguity of the results obtained in empirical studies on savings' responsiveness to interest rates (see, for example, Gonzalez-Arrieta 1988), there is more or less a consensus that raising real interest rates in financially repressed economies is important for at least three reasons:

1. It would discourage domestic investment projects not yielding an adequate rate of return over the long run.
2. *Ceteris paribus*, high real rates of interest may raise both domestic and foreign savings and thus total savings.
3. Realistic real interest rates would abolish rationing of loan funds and therefore the distortions derived from financial repression. This is expected to increase the flow of savings through the financial system and hence the overall efficiency of the saving investment process.

The phenomenon of financial repression in Tanzania during 1967–1980 coupled with restrictions on entry into the financial system had disintermediation effects, as is indicated by the decline in the ratio of total nonmonetary assets to total wealth (see Table 9.1).[4] Moreover, low interest rates, together with overvaluation of the shilling, have been cited as contributing to the bias of investment toward capital- and import-intensive technology in Tanzania (see Wangwe 1983). That characteristic has contributed in turn to the low utilization of total capacity that is associated with industrial sector inefficiency.

One of the central bank functions, apart from overseeing external and domestic monetary stability, is to promote the growth of a sound financial market. This responsibility has several aspects. First, a prerequisite for specialization in the financial industry is the freedom of financial institutions to design their products (financial assets) in a way that differentiates the products of financial intermediaries from one another. This variation is accomplished by different combinations of the attributes of yield, liquidity, risk, and convenience. I have argued above that interest rate regulations inhibit such innovations. Second, once a primary market for securities is formed, financial policies have to be modeled in a way that promotes the establishment of a secondary market, where financial assets already ac-

quired may be actively traded to increase their liquidity. A financial asset that has to be held by the initial buyer up to maturity because of the absence of a secondary market is not only illiquid but also carries high risk in terms of interest, safety, and convenience. Under such circumstances real (physical) assets may offer more liquidity and less risk than a financial asset, in which case economic units will run away from financial assets.

The Tanzanian financial experience shows that the authorities have not attempted to develop the secondary market for securities. During the East African Currency Board (EACB) period, however, there were strong efforts to develop the treasury bills market, and by 1964 the market was relatively active (EACB 1965). In fact, before the breakup, the board had proposed to establish a two-tier central banking structure and common treasury bill instrument for the whole of East Africa in order to allow a greater float of securities and more activity in the market (Kimei 1986: 64). The total volume of treasury bills traded in the market amounted to about 500 million East African shillings in 1984—which in 1988 exchange rates would have worked out to about Tanzanian shs. 10 billion, equivalent to some 5 percent of the country's GDP for 1987. The independent national central banks that emerged in East Africa from June 1966, however, particularly the BOT, never continued the strategy of encouraging a secondary market for government securities as an embryo of fully fledged money and capital markets.

The absence of a secondary security market from the financial system has had very damaging effects. This is especially true because of the savings institutions that have either statutorily or by nature of their liabilities been compelled to invest largely in government paper. The most prominent examples are the POSB and the contractual savings institutions (the NPF and the NIC). The law establishing the POSB requires that it invest all excess deposits in government securities. After the recent changes in the interest rate structure (prescribed by the BOT), the rates on savings deposits were raised from 10 percent in October 1985 to 15 percent in July 1986 and subsequently, in April 1987, to 21.5 percent. Three months later, in July, the rate was increased again to 23 percent and then to 29 percent in December 1988.

Those rates at which the POSB must pay depositors have been consistently higher than the rates of interest on government securities in which it must invest. During the corresponding period the average rate of interest on government securities moved from 8.5 percent in October 1985 to 13.6 percent in July 1986 and, respectively, 18.9, 20.8, and 21.8 percent in April 1987, July 1987, and December 1988. The result has been a shortfall of interest earned on investment as compared with interest paid by the POSB on deposits. With slight exceptions, the amount of interest payments on deposits in relation to the amount of interest income from investment in

government securities has risen steadily since 1975. By 1986 payments on deposits were 135 percent of investment receipts.

As for savings in the form of life policies and pension contributions to the NIC and the NPF, the implicit rates of capitalization have been depressed by the relatively low rates on government securities, to which the savings are mainly deployed. In particular, while the inflation rate has averaged slightly over 30 percent in the period 1980–1988 (depending on the price index used), the average capitalization rate used by the NIC (and probably the NPF) has been only 8 percent per annum plus a bonus averaging about 1 percent per annum during 1970–1988. While this rate might have been realistic in the late 1960s and early 1970s, when inflation was below 10 percent, it was drastically eroded by inflation from the second half of the 1970s to become substantially negative in real terms. Given this rate of return on life savings with the NIC (and the NPF) and an average inflation rate of 21 percent over the period 1970–1988, a saving of shs. 100 made in 1970 is now worth shs. 16.3 only in real terms. The main cause for the drastic erosion of life savings turns out to be the prescribed low yields on the government stock constituting the major form in which these savings are invested. Irrespective of the causes for the low yields, the main issue of concern should be the discouragement of savings that results from the inflation tax.

The performance of financial institutions is directly related to the quality and motivation of their staff. Properly recruited and motivated bankers work efficiently, being responsive to customer demands and effecting mobilization and allocation of resources to projects offering maximum returns at least risk. The main motivation of employees results from their remuneration in real terms. The latter problem is primarily related to the country's high inflation record (see Figure 9.1 and Table 9.3), and basic to understanding its controllability is an analysis of the sources of liquidity expansion in Tanzania.

In Tanzania the contribution to expansion in broad money of credit to the expanded public sector—the central government and the state-owned enterprises combined—rose from an average of 64 percent in 1970–1975 to 109 percent during 1981–1986 (see Table 9.4). As a result credit to the private sector recorded a declining share in the growth of the money supply, averaging 21 percent and 7 percent during 1970–1975 and 1981–1986 respectively. Only in the period after June 1986 did the contribution of bank credit to the private sector start to pick up, reaching 25 percent in June 1988. The foregoing trend suggests that the government and the public sector at large have been the major source of liquidity expansion and inflation in Tanzania, especially in the past ten years or so. Nevertheless, the inflation created by the government was not on account of increased wages but rather on purchases on nonwage goods—and sometimes the purchases of fictitious and overinvoiced goods.[5] In this connection, during the

TABLE 9.4

Sources of Money Supply, 1970–1988 (years ended June, percent)

Monetary survey April 12, 1989 2:51 P.M.	1970	1975	1981	1982	1983	1984	1985	1986	1987	1988
Foreign assets (net)	33.1	17.1	4.1	3.1	6.5	−25.1	−27.7	−25.6	−34.5	−28.3
Net domestic assets	66.9	82.9	95.9	96.9	93.5	125.1	127.7	125.6	134.5	128.3
Domestic credit	70.5	99.0	108.3	109.5	107.5	123.7	128.2	119.7	133.2	122.2
Claims on government (net)	12.2	39.3	67.3	70.9	70.9	80.9	82.8	64.7	50.4	43.5
Claims on SOEs and private	58.3	59.7	41.0	38.6	36.5	42.8	45.4	55.1	82.8	78.7
Major parastatals (including co-ops)	29.5	46.9	34.8	31.4	29.8	39.7	41.6	39.2	70.2	53.8
Other	28.8	12.8	6.2	7.1	6.7	3.0	3.8	15.9	12.7	24.9
Other items (net)	−3.6	−16.1	−12.4	−12.6	−13.9	1.4	−0.5	5.9	1.3	6.0
Money and quasi money	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Money	76.6	77.4	74.4	74.1	70.6	68.0	64.8	71.1	70.9	72.7
Currency outside banks	35.5	31.3	32.0	32.3	28.1	34.7	32.6	36.4	37.0	35.4
Demand deposits	41.1	46.1	42.5	41.8	42.5	33.3	32.2	34.8	34.0	37.3
Quasi money	23.4	22.6	25.6	25.9	29.4	32.0	35.2	28.9	29.1	27.3
Time deposits	14.7	14.1	17.9	18.3	21.2	22.5	25.2	19.1	19.1	16.2
Saving deposits	8.8	8.5	7.7	7.6	8.2	9.5	10.0	9.8	9.9	11.1

SOURCE: Bank of Tanzania.

eighteen-year period beginning in 1970, the minimum wage in real terms (1977 prices) saw a decline of over 70 percent, from shs. 400 in 1970 to shs. 115 in 1988 (see Table 9.5). The average real wage in Tanzania tends to correspond with the administrative adjustment of the minimum wage rate because these adjustments set the tone of reviews of the other salary scales, usually, a rise in the minimum wage rate substantially exceeds increases in the above-minimum scales.

To the extent that public sector bank borrowing greatly exceeds credit extended to the private sector, it becomes inconceivable that monetary policy could have been effective in sterilizing the implications of the fiscal stance on monetary expansion given the specific conditions in Tanzania. We may therefore conclude that the wage and income policy of the government has been the major factor explaining real wage deterioration in the country—and with that the decline in motivation, work incentives, creativity, and productivity in general and erosion of banking ethics in particular.

Weaknesses of commercial banks in Tanzania (especially the NBC). The commercial banking sector in the Tanzanian mainland was under the monopoly of the NBC until 1984, when the CRDB was given commercial banking privileges. Even then, up to 1988, the CRDB remained relatively small, accounting for some 7 percent of all bank deposits. Among the financial institutions in the country, only the NBC and the THB engaged in deposit mobilization—the THB accepting savings and term deposits only. The performance of the NBC in both deposit mobilization and deployment has been discouraging over the entire period, but especially in the 1980s. Total NBC deposits in real terms declined throughout 1980–1987, reversing the trend recorded in the 1970s (see Table 9.2). Thus, whereas total NBC deposits in real terms rose at an average rate of 12.5 percent

TABLE 9.5

Real Minimum Wage and Its Growth, 1970–1988 (selected years)

	1970	1975	1980	1985	1988
National consumer price index (1977 = 1.00)	0.4	0.8	1.6	5.9	13.5
Nominal minimum wage (shillings)	170.0	380.0	480.0	800.0	1,560.0
Real minimum wage (1977 prices)	400.0	477.4	306.3	136.7	115.1

SOURCE: International Labor Organization, "Basic Needs in Danger," Addis Ababa, 1982, p. 268; budget speech, 1987/88.

during 1971–1979, they declined at an average rate of 9.4 percent annually during 1980–1988 (see Table 9.6).

It is noteworthy that during the period when the degree of financial repression (expressed by the negative real interest rates on deposits) was mild (1971–1979), interest-earning deposits grew slower than the demand deposits (non-interest-earning). In the period 1980–1988, however, when financial repression intensified, both demand and interest-earning deposits declined, the latter falling at a slower pace. These trends are contrary to theoretical expectations and suggest that interest rate policy may not be the principal factor explaining the deposit mobilization performance of the NBC. Therefore, one has to look at Table 9.6 for institutional factors to explain the underlying trends.

The author was privileged to attend some of the discussions convened by members of the Presidential Commission of Enquiry into the Monetary and Banking System in Tanzania. The meetings involved both clients and management of the financial institutions, including the NBC. The following factors were repeatedly cited at all forums as the major impediments to the public use of NBC as a depository or as a source of loans:

On handling of deposit accounts

1. poor customer services on NBC counter coupled with time-consuming queues at times of depositing and withdrawing
2. complete lack of bank secrecy with the result that information about depositors' accounts flows at ease to interested parties—tax authorities, anticorruption squad, individuals, and so on
3. deterioration of confidence in the bank as a safe custodian, given the large and increasing number (and amounts) of thefts, forgeries, and frauds made public through the media
4. in connection with 3. above, failure of required statements of accounts to be prepared and mailed to customers; even when the customers follow them up they are received after a long time on the counter, and, worse still, turn out to be inaccurate
5. the collapse of confidence in the check and bankers' draft as a payment instrument because of, among other things,
   - nonacceptance of the bankers' draft for encashment at sight and the long time taken to verify authenticity with the issuing branch
   - increased cases of bounced checks due to laxity in the implementation of the Cheques Act, 1969
   - increased forgeries of checks by collaboration between bank staff and the public
6. long delays in remittance of funds by telegraphic transfers (TTs), despite high commissions charged for the service—it was alleged that a

TABLE 9.6
Trends in NBC Deposits, 1967–1988

End of period	Consumer price index (1977=1)	Demand deposits DD	Saving deposits SD	Time deposits TD	Interest earning (SD+TD)	Total deposits (DD+SD+TD)	Growth rate (SD+TD)	Growth rate total deposits	Nominal interest (1-yr savings)	Real interest (1-yr savings)
1967	0.379	622.3	128.4	120.7	249.1	871.4			3.5	
1968	0.385	552.8	149.0	207.9	356.9	909.7	43.3	4.4	3.5	1.9
1969	0.410	630.2	159.2	314.4	473.6	1,103.8	32.7	21.3	3.5	−3.0
1970	0.424	683.1	182.5	290.6	473.1	1,156.2	−0.1	4.7	3.5	0.1
1971	0.441	1,095.7	199.4	379.1	578.5	1,672.2	22.3	44.6	3.5	−0.5
1972	0.479	1,107.0	239.0	466.0	705.0	1,812.0	21.9	8.4	3.5	−5.1
1973	0.528	1,336.0	303.0	504.0	807.0	2,143.0	14.5	18.3	4.0	−6.2
1974	0.632	1,794.0	362.0	558.0	920.0	2,714.0	14.0	26.6	4.0	−15.7
1975	0.796	2,575.0	433.0	640.0	1,073.0	3,648.0	16.6	34.4	4.0	−21.9
1976	0.851	3,306.0	523.0	852.0	1,375.0	4,681.0	28.1	28.3	4.0	−2.9
1977	0.950	3,762.1	643.9	1,255.1	1,899.0	5,661.1	38.1	20.9	4.0	−7.6
1978	1.066	4,176.5	758.9	1,454.7	2,213.6	6,390.1	16.6	12.9	5.0	−7.2
1979	1.204	6,042.8	930.5	2,029.6	2,960.1	9,002.9	33.7	40.9	5.0	−7.9
1980	1.567	5,366.0	1,173.4	2,503.6	3,677.0	9,043.0	24.2	0.4	5.0	−25.1
1981	1.969	5,699.7	1,439.5	3,051.4	4,490.9	10,190.6	22.1	12.7	6.0	−19.7
1982	2.539	7,032.2	1,746.5	4,070.9	5,817.4	12,849.6	29.5	26.1	7.5	−21.4
1983	3.226	7,909.2	2,213.1	5,339.2	7,552.3	15,461.5	29.8	20.3	7.5	−19.6
1984	4.392	9,635.9	2,584.5	6,279.9	8,864.4	18,500.3	17.4	19.7	7.5	−28.6
1985	5.854	11,145.8	3,006.8	7,212.9	10,219.7	21,365.5	15.3	15.5	10.0	−23.3
1986	7.752	12,585.4	4,124.1	9,051.1	13,175.2	25,760.6	28.9	20.6	15.0	−17.4
1987	10.074	15,705.1	5,210.4	9,250.2	14,460.6	30,165.7	9.8	17.1	24.0	−6.0
1988	13.197	21,776.3	7,320.4	10,444.7	17,765.1	39,541.4	22.9	31.1	29.0	−2.0

Real magnitudes										
1967	0.369	1,642.0	338.8	318.5	657.3	2,299.2			3.5	
1968	0.385	1,435.8	387.0	540.0	927.0	2,362.9	41.0	2.8	3.5	−0.8
1969	0.410	1,537.1	388.3	766.8	1,155.1	2,692.2	24.6	13.9	3.5	−3.0
1970	0.424	1,611.1	430.4	685.4	1,115.8	2,726.9	−3.4	1.3	3.5	0.1
1971	0.441	2,480.0	452.2	859.6	1,311.8	3,791.8	17.6	39.1	3.5	−0.5
1972	0.479	2,311.1	499.0	972.9	1,471.8	3,782.9	12.1	−0.2	3.5	−5.1
1973	0.528	2,530.3	573.9	954.5	1,528.4	4,058.7	3.8	7.3	4.0	−6.2
1974	0.632	2,838.6	572.8	882.9	1,455.7	4,294.3	−4.8	5.8	4.0	−15.7
1975	0.796	3,234.9	544.0	804.0	1,348.0	4,582.9	−7.4	6.7	4.0	−21.9
1976	0.851	3,884.8	614.6	1,001.2	1,615.7	5,500.6	19.9	20.0	4.0	−2.9
1977	0.950	3,960.1	677.8	1,321.2	1,998.9	5,959.1	23.7	8.3	4.0	−7.6
1978	1.066	3,917.9	711.9	1,364.6	2,076.5	5,994.5	3.9	0.6	5.0	−7.2
1979	1.204	5,018.9	772.8	1,685.7	2,458.6	7,477.5	18.4	24.7	5.0	−7.9
1980	1.567	3,424.4	748.8	1,597.7	2,346.5	5,770.9	−4.6	−22.8	5.0	−25.1
1981	1.969	2,894.7	731.1	1,549.7	2,280.8	5,175.5	−2.8	−10.3	6.0	−19.7
1982	2.539	2,769.7	687.9	1,603.3	2,291.2	5,060.9	0.5	−2.2	7.5	−21.4
1983	3.226	2,451.7	686.0	1,655.1	2,341.1	4,792.8	2.2	−5.3	7.5	−19.6
1984	4.392	2,194.0	588.5	1,429.8	2,018.3	4,212.3	−13.8	−12.1	7.5	−28.6
1985	5.854	1,904.0	513.6	1,232.1	1,745.8	3,649.7	−13.5	−13.4	10.0	−23.3
1986	7.752	1,623.5	532.0	1,167.6	1,699.6	3,323.1	−2.6	−8.9	15.0	−17.4
1987	10.074	1,559.0	517.2	918.2	1,435.4	2,994.4	−15.5	−9.9	24.0	−6.0
1988	13.197	1,650.1	554.7	791.4	1,346.2	2,996.3	−6.2	0.1	29.0	−2.0

SOURCE: Bank of Tanzania.

TT between two main towns like Arusha and Dar es Salaam was sometimes taking over a month, making such transfers pointless.

On handling of client borrowers

1. long, bureaucratic, and complicated procedures in processing loan and overdraft applications, resulting mainly from centralization of decision making at the NBC headquarters—even in respect of amounts that at the prevailing purchasing power of the shilling appear to be quite small—causing delays (of to over half a year) in approvals and disbursements of loan facilities
2. underfinancing of projects and activities resulting from delays in processing loan applications in a hyperinflationary environment (coupled with exchange rate volatility)
3. little interest of bankers in borrowers' projects to be financed and in the borrowers' reputation in the bank and undue emphasis on availability of tangible security or title deeds on land as preconditions for loan approvals
4. inadequate loan follow-up to ensure proper end use
5. in some instances, need for clients to provide substantial amounts in bribes for their loans to get approvals

The foregoing list of clients' complaints about the operations of the NBC is not exhaustive, but they were the most frequently and emphatically expressed. It should be noted, however, that whereas depositors rarely complained about interest rates as a deterrent to savings, borrowers felt that the recent revision of the interest rate structure had brought them to levels that were prohibitive for small, productive, non-export-oriented businessmen. Thus savers appeared to be only marginally responsive to interest rate changes, whereas long- and medium-term investors seemed very responsive to changes in loan rates.

The bank's management response to the clients' complaints. In response to some of the complaints given in the preceding paragraphs, the NBC management offered the following:

- The hiring, firing, and motivation of staff in the financial institutions in general is seriously impaired by the complexity and inflexibility of civil service staffing guidelines, including the direct controls by the presidential Standing Committee on Parastatal Organizations (SCOPO), and the Security of Employment Act of 1964. The latter complicates and almost rules out the possibility of employers' sacking inefficient or undisciplined employees.
- Rapid branch expansion with the intention of bringing banking services to remote areas could not be matched by equiproportionate growth in

administrative/manpower capacity (quantitatively and qualitatively) because of limited resources.

- Overall economic infrastructure—particularly communications—has been inefficient, with the result that interbranch communication through the post offices is impaired. The latter is allegedly the cause of delays in TTs and other instruments used in transferring funds.
- Technology is outdated.
- More important, on the efficiency of lending operations, the NBC has had little or no control at all over limits of exposure to its major clients—the parastatals, marketing boards, and cooperative unions. The government and the party authorities have forced the bank (by providing guarantees or mere directives) to extend loans and overdrafts to these institutions, even when the bank's evaluations indicate that the intended uses were nonviable. As a result the bank's loan recovery rate has deteriorated, and up to about 70 percent of its loan portfolio is considered nonperforming.
- The bank's terms of lending and of deposit mobilization are determined by the monetary authorities, and this, other things being equal, determines its profitability.

Overall Interpretation of Tanzania's Financial Sector Performance

The problems facing the Tanzanian financial system—as represented by the NBC—boil down to four fundamental issues: first, absence of competition; second, an inadequate monetary policy framework; third, weaknesses inherent in the macroeconomic environment, especially the question of capital adequacy and solvency of major borrowers; and, finally, inadequacies in the regulatory framework.

Absence of competition. The recorded deterioration in customer services, innovation, and banking ethics within the NBC, and indeed in other financial institutions as well, is principally attributable to lack of competition in the financial market. This has been eloquently put by one of the clients of the NBC, Salum Shamte, who noted, "The NBC has for a long time had a stronghold on the common man who has no alternative, but needs banking services." Unfortunately, the NBC has grown lax and has completely forgotten that depositors and borrowers are its customers, without whom it would have no reason for being. The absence of competition leaves those users with no alternative and allows bad service to be simultaneously the best available. The presence of competition will not allow the bad to be also the best.

The NBC's monopolistic position in the commercial banking business in Tanzania, like that of the other specialized financial institutions in their respective sectors, has some specific elements. First, although the NBC is required by its statute to observe commercial principles in its operations, the bank has no control over its deposit and loan rates of interest. Second, in practice the NBC has been operating under severe political pressure, with the result that most of its branch expansion and lending decisions have been made under the influence of politicians.

Because of absence of competition the array of savings instruments offered by the NBC has been quite limited. The schemes in force include counter services, a payday collection scheme, payment of salaries through bank accounts, mobile agency services, an estate agents scheme, a deposit life insurance program (run jointly with the NIC), a school banking and minors plan, a money boxes scheme, and a cumulative deposit program. None of these various schemes provide additional means of payments whereby there is an array of instruments with differentiated degrees of liquidity and market risk. One may doubt, therefore, that the financial system in Tanzania has been sufficiently innovative in producing instruments that are well differentiated in degrees of liquidity, yield, riskiness, marketability, and convenience of access—and, for that matter, in successful savings mobilization.

Inadequacy of the monetary policy framework. The responsibility for the conduct of monetary policy in Tanzania rests with the BOT. The act establishing the central bank gives it all the traditional powers and instruments for regulating monetary aggregates, including such tools as reserve and liquidity ratios, interest rate policy, open market operations, and selective credit policy. The premise of competitive banking, however—under which the inaugural BOT Act was enacted—was altered by the adoption of the Arusha Declaration of socialist policies in 1967. This was followed by the nationalization of banks and other key financial institutions, making it imperative that the thrust of monetary policy change. The desire to effect monetary policy more selectively, to redistribute resources in favor of the public sector, entailed greater reliance on direct instruments of credit control. Nevertheless, it was not until 1978 that the BOT Act was amended for the purposes of giving the central bank more direct instruments of monetary control, although the introduction of annual financial planning in 1971–1972 had necessarily rendered the application of traditional monetary policy instruments redundant.

During the initial period of independent central banking, 1966–1971, pressure on bank credit demand was relatively low, largely because the government maintained approximate fiscal balance, as its investment remained limited by low project implementing capacity. Under these circumstances moral suasion was the main approach to attainment of monetary stability. In the early 1970s, however, the demand for financial

resources was projected to be much higher than could be afforded by noninflationary monetary expansion. In a bid to ration the limited resources in favor of the public sector, the Annual Finance and Credit Plan and the Foreign Exchange Plan were introduced in 1971–1972 as major instruments of monetary policy, aided by secondary instruments like interest rates, variable reserves, and liquidity requirements. Over the period 1972–1982, however, the latter types of tools were rarely used. For example, over the ten-year period 1970–1980, the interest rate structure was adjusted only twice while reserve and liquidity requirements remained constant. Only in the recent period, 1985–1988, has interest rate policy been relatively active, changes in the structure taking place two or three times a year, as described early in this chapter in the section "Weaknesses of the Bank of Tanzania."

The key variables of the finance and credit plans have been domestic credit formation, comprising bank lending to government and nongovernment sectors, money supply targets, and net foreign assets. The last is projected in the Foreign Exchange Plan.

The essence of financial planning is to ensure that the savings mobilized by the financial system are made available to the various economic activities according to socioeconomic priorities of the government, without disturbing domestic and external monetary stability. Thus the Annual Finance and Credit Plan provides the targets for credit to government, credit to various sectors other than government, and growth in the money supply. The starting point for projecting the expansion of credit is a combination of anticipated real income growth and assumptions regarding inflation. Within the parameters of noninflationary monetary growth and the net foreign assets, it is then possible to determine the dimensions of credit formation in the economy. Bank credit to government is normally derived from the budget estimates, so that the rest of the economy gets the residual. Within the latter group of sectors, however, credit is distributed between specified crop-marketing authorities (marketing boards and cooperative unions) and the rest of the nongovernment sectors. Usually, because of slow stock turnover, the crop-marketing authorities tend to account for over 50 percent of total credit expansion. Credit requirements for the crop-marketing authorities are estimated on the basis of expected production, producer prices, administration, handling and processing costs of the crop boards, expected quantity of sales (export and local), and expected export and local selling prices.

The attainment of the Finance and Credit Plan targets has been made difficult by, among other factors (see Kimei 1986: chap. 5)

- excessive (over and above desired) credit demand arising from stock buildup and trading losses particularly by crop-marketing institutions (the former results mainly from transportation and processing bottlenecks, while the latter arise from a combination of factors, includ-

ing pricing policies, behavior of international commodity prices, and management efficiency)

- difficulty in resisting political pressure on banks to extend credit to particular parastatals irrespective of their credit-worthiness—with the result that a substantial chunk of bank credit is nonperforming, thereby weakening the liquidity position of the banks
- the problem of controlling government borrowing from the banking system

As mentioned earlier, the BOT has not actively followed up the implementation of the Finance and Credit Plan by backing it up with supportive monetary policy instruments at its disposal (interest rate policy, for example). On the contrary, the central bank itself has in most cases yielded to political pressure by accepting an accommodation of what are perceived as "special credit needs" even after the drawing up of the financial plan. This has exacerbated the overshooting of planned monetary aggregates—a process that has fueled inflation in Tanzania (see Figure 9.1 and Table 9.3 for Tanzania's inflationary trends).

Apart from the preemption of monetary policy instruments by financial planning, the use of traditional monetary policy instruments in Tanzania is further impaired by the following major characteristics of the financial market and the economy in general.

A low degree of monetization is a result of the monetary controls (used and not used) that may leave a substantial part of the economy unaffected (see Pendharkar and Narasimham 1966). The national accounts of Tanzania have not attempted to estimate separately the contribution of subsistence production to the GDP in the past five years or so. The share of subsistence production, however, has risen since the entry of the economy into high inflation episodes from the mid-1970s. In this connection, during 1974–1981 the value of subsistence production in real terms (1966 prices) rose at an average rate of about 5 percent while GDP rose at an average rate of about 4 percent (see Kimei 1986: 48). Evidence suggests that over the period 1981–1988 the share of the subsistence sector continued to increase. In this regard primary production (into which most subsistence activities fall) has increased its share of GDP substantially, from 45 percent in 1980 to 61 percent in 1988. Assuming that the share of subsistence production in GDP has been roughly equal to 50 percent of that of primary production (as it was in the mid-1970s), then that share may be estimated to have risen from about 23 percent in 1980 to 31 percent in 1988.

The increase in informal financial sector operations. The term "informal financial sector"—also referred to as "unorganized financial sector" or "noninstitutional financial sector"—covers all financial activities outside the gambit of institutional finance (Hart 1973). The most important characteristics of this sector include (Chandavarkar 1988)

- proprietary or mutual ownership, for example, *Upato* schemes in Tanzania
- complete freedom of entry and exit, which makes the market more or less perfectly competitive
- low costs of transactions and information gathering because of informality of transactions and intimate knowledge of customers on part of lenders
- freedom from central bank controls, such as cash reserve and liquidity ratios, interest rate and portfolio ceilings, and selective controls
- higher effective rates of interest than in the institutional financial sector
- evasion of implicit taxation of the institutional sector through preemption of government funds at repressed rates of interest and subsidized borrowing by some institutional sectors
- much less controlled end use of credit and less discrimination of credit for consumption purposes

The informal financial sector partly reflects the activities of the so-called parallel economy, which is essentially a mechanism of evading taxes and other financial controls including credit and foreign exchange regulations (see Tanzi 1982). Strictly speaking, the informal financial sectors are not independent of the formal. In most cases the noninstitutional lenders borrow from the formal money markets for relending in the informal sector. As a result official credit policy (whether squeezing or relaxing bank lending requirements) has some impact on the availability of credit in the informal sector. To the extent that users rely on the informal financial sector for meeting their credit needs or for deploying their savings, the sector may be seen as a cause of financial disintermediation—certainly in the official sector. As this occurs, the potential effectiveness of monetary policy is eroded, and fragmentation of money and capital markets is accelerated, further hampering efficient mobilization and deployment of savings.

In Tanzania the parallel market took strong root beginning in the early 1980s when commodity and foreign exchange scarcities became acute. Further, given that the minimum subsistence wage in Dar es Salaam is currently estimated at over shs. 6,000 per month (based on the Household Budget Survey, 1976–77, and current market prices) while the official actual rate is about shs. 1,500 per month, one may assume that the gap (about 75 percent) is largely met through informal activities. Moreover, as pointed out earlier, credit rationing in favor of the public sector through annual finance and credit plans from 1971 onward has severely constrained credit availability to the private sector, especially for not directly productive sectors and consumption. It is, therefore, quite plausible that informal financial arrangements have grown rapidly in the past ten years.

No attempt has been made to estimate the size and activity of the informal sector in general, and the informal financial sector in particular, in Tanzania. The available ad hoc evidence indicates, however, that the size and scope of that sector are sizable. It is reported that one survey found only one of seventy-one informal establishments admitting to having obtained a loan from a formal financial institution—and that one case involved a meager loan of shs. 15,000 from the NBC. Thirty establishments (42 percent) acknowledged obtaining loans from relatives and friends, while 37 percent of establishments confirmed having obtained credit from other informal trade dealers.

Volatility of the money multiplier. Since the liabilities of the noninstitutional financial sector do not possess the attributes of money and currency is the predominant transactions medium, informal sector credit operations do not create a significant flow of deposits. Thus the informal financial sector is not able, in and of itself, to fulfill the norm of banking practices and match credit formation with deposit creation. As a result the money multiplier in an economy with a growing informal financial sector tends to be dampened (Chandavarkar 1988: 85). The behavior of the money multiplier in Tanzania over the period 1975–1987 is presented in Table 9.7. In

TABLE 9.7
The Money Multiplier, 1975–1987

Period	Currency in circulation	Commercial bank deposits with BOT	Base money	Money (M2)	Money multiplier
1975	1,862.9	15.8	1,878.7	5,552.7	3.0
1976	2,214.9	14.7	2,229.6	6,946.8	3.1
1977	2,565.0	38.3	2,603.3	8,346.0	3.2
1978	3,143.5	12.4	3,155.9	9,396.3	3.0
1979	4,278.2	109.9	4,388.1	13,806.6	3.1
1980	5,522.9	39.3	5,562.2	17,519.9	3.1
1981	6,950.0	186.8	7,136.8	20,694.7	2.9
1982	8,381.9	244.8	8,626.7	24,728.6	2.9
1983	8,717.3	176.4	8,893.7	29,078.3	3.3
1984	11,341.2	230.1	11,571.3	30,218.1	2.6
1985	13,556.6	473.4	14,030.0	38,971.0	2.8
1986	19,451.6	269.5	19,721 1	50,353.4	2.6
1987	26,329.0	1,554.0	27,883.0	62,777.9	2.3

SOURCE: Bank of Tanzania.

line with the foreign argument, the money multiplier, which had remained slightly above 3 in the 1970s, started a downward trend from 1980, reaching as low as about 2.3 in 1987.

The volatility of the money multiplier renders unachievable any attempt to control the money supply through the monetary base. In this connection reserve requirements—which are a major means of controlling base money—turn out to be an inefficient monetary policy instrument.

Unpredictability of the demand for money as measured by the velocity of money circulation. Over the past two decades the demand for money in Tanzania—proxied by the income velocity of narrow or broad money—has been extremely unstable (see Table 9.8 and Figure 9.2). This behavior cannot be a surprise in an environment that has been characterized by severe economic shocks, of both external and domestic origin. The implication of the behavior, however, is that the monetary authorities cannot exert effective control over the monetary aggregates and hence inflation.

Absence of an active secondary market for securities. Among the most popular tools of monetary policy is open market operations through which liquidity can be contracted or injected into an economy by a central bank selling or buying of marketable securities. The evolution of a securities market may follow demand, provided that market interferences are

TABLE 9.8
Velocity of M2 and M1, 1975–1988

Period	Nominal GDP	Broad money (M2)	Narrow money (M1)	Velocity of M2	Velocity of M1
1975	17,824.20	5,552.70	4,346.40	3.21	4.10
1976	21,652.00	6,946.80	5,331.80	3.12	4.06
1977	25,698.00	8,346.70	6,382.80	3.08	4.03
1978	28,582.00	9,396.30	6,827.00	3.04	4.19
1979	32,317.00	13,806.60	10,435.40	2.34	3.10
1980	37,454.00	17,519.90	13,345.90	2.14	2.81
1981	43,906.00	20,694.70	15,401.20	2.12	2.85
1982	52,546.00	24,728.60	18,323.20	2.12	2.87
1983	61,008.00	29,078.30	20,537.10	2.10	2.97
1984	76,264.00	30,218.10	25,270.20	2.52	3.02
1985	99,330.00	38,971.00	35,809.50	2.55	2.77
1986	143,034.00	50,353.40	45,091.50	2.84	3.17
1987	198,101.00	66,442.90	47,130.60	2.98	4.20
1988	263,500.00	89,809.00	65,400.90	2.93	4.03

SOURCE: Bank of Tanzania.

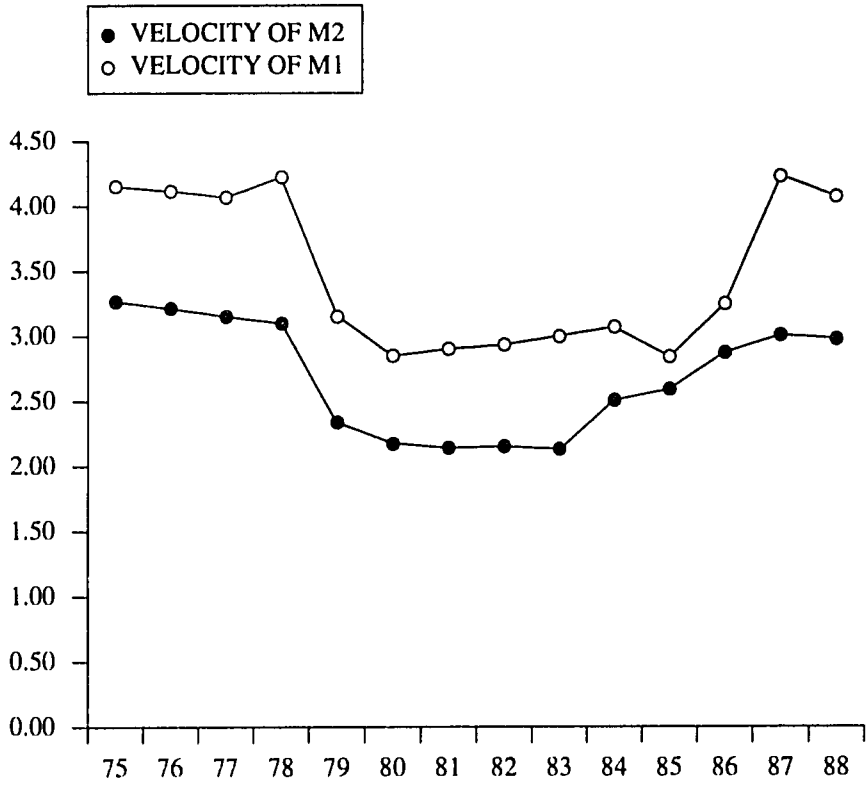

Figure 9.2. Income Velocity in Tanzania, 1975–1988
SOURCE: Bank of Tanzania.

minimal—so that supply and demand are the major determinants of the rates of return (or interest rates) in the market. In a regulated economy, as in the Tanzanian case, the promotion of a securities market should be taken as a deliberate policy action if such a market is to grow at all.

Non-profit-maximizing nature of financial institutions. For the traditional monetary policy instruments to become effective, the banks and other financial intermediaries constituting the subjects of monetary controls have to be profit maximizers (or cost minimizers). If the institutions are indifferent to profit and costs, the instruments will be rendered redundant. An example, drawn from Tanzania's experience, may illustrate this. During the late 1970s and early 1980s the commercial banks and, indeed, other financial institutions in Tanzania were awash with funds (see Nyriabu 1980: 4–5). An imposition of reserve requirements with a view to reducing lending capacity and hence monetary formation under such circumstances may be ineffective. Moreover, an increase in the central discount rate, with a view to compressing aggregate demand might—

under non-profit-maximizing banks—not trigger the expected general rise in interest rates and for that matter might be preempted as a contractionary monetary measure. Thus, for example, in Tanzania the sharp increase in the bank discount rate from about 135 percent in 1987 to 22 percent in 1988 (a level almost at par with the prevailing interest rate on savings deposits) did not induce a reduction in commercial bank's recourse to the BOT. On the contrary, commercial bank borrowing from the central bank continued in an upward trend, registering an annual rise over 250 percent in the year ended June 1988.

Weaknesses inherent in the macroeconomic environment. The macroeconomic environment in Tanzania has most likely been responsible for an inefficient financial system. The administrative regulations on the markets for goods, labor, capital, and land, which were intensified after the Arusha Declaration of socialist orientation of 1967, have implied severe distortions of market signals. Several major regulations were introduced into the respective markets during the period 1967–1985, as discussed in the following.

Regulations on the goods market. Price controls were first introduced in 1967 but were not institutionalized until the formation of the National Price Commission in 1973. Agricultural producer prices have been under direct government control since 1967. Commodity confinement policy, under which trade in all major capital and consumer goods as well as intermediate inputs was confined to specialized national and regional trading companies, was introduced in 1972 and strengthened from 1979–1980. Import licensing was introduced in 1971, first with an open general license (OGL) list of goods that were automatically licensed and later from 1981 without the OGL when foreign exchange scarcity worsened.[7]

Generally speaking, the controls on the goods market have in one way or another affected the financial performance of the nonfinancial institutions that constitute the clients of financial intermediaries.

Regulations on the labor market. The labor market has been controlled in three main ways—by imposing minimum wage and salary regulations; by ensuring full control over the worker's union to rule out an effective wage bargaining process; and by imposing direct government regulation of general terms of employment in the parastatal sector through the Standing Committee on Parastatal Organizations (SCOPO).

The result of these regulations—which also hold for financial institutions—has been to deprive employers of their creativity in ways and means of motivating employees for increased productivity. This has been reinforced by the fact that regulations apply more or less uniformly across sectors, without due regard being paid to industry specificities.

Financial market regulation. The previous sections have mentioned various financial regulations such as nominal interest rate ceilings and

credit rationing by the mechanism of the finance and credit planning. The other crucial regulation that has to be added is the restriction of entry and exit of institutions into the financial arena, which is rooted in the acts of establishment of the NBC and other financial institutions. The latter has had negative implications for competition and hence for innovation and efficiency.

Other environmental weaknesses. One of the most important characteristics and weaknesses of Tanzania's financial sector as a whole is the pressure imposed by a high incidence of nonperforming loans. The explanations given by the management of the NBC for poor loan recovery rates are as follows:

- Inadequate capital structure of the major borrowers—the parastatals and cooperative unions—which have been compelled to divert short-term credits (crop finance and so on) to financing of fixed assets, as they were given little, if any, capital at the time of establishment. This is the other side of the proposition advanced earlier, that the government overstretched its resources by attempting to have command over everything (even over what do not appear to be commanding heights, like butcheries and football associations). This overstretching has contributed not only to inflationary financing of the budget but also to the capital inadequacy of institutions established by the government (state-owned enterprises).
- Controlled pricing of some commodities—particularly food grains—has entailed substantial subsidies to the parastatals handling the goods. The government's failure to disburse the subsidies in a timely manner (because of budgetary pressure) has deterred the parastatals from retiring bank credit extended to them year after year. A good example of this is the National Milling Corporation (NMC), of which overdue credit outstanding on its account at the end of June 1988 accounted for about 20 percent of total bank credit to nongovernment sectors by the NBC.
- Unrealistic exchange rate management: An overvaluation of the shilling exchange rate, coupled with administrative fixing of producer prices and autonomously determined processing and handling costs for Tanzania's major exports, led to a situation whereby a large number of the export parastatals became substantial loss makers. The major contributory element to the losses was unrealistic pricing of foreign exchange earnings during 1978–1988. The basic question that arises is the way in which the losses suffered by the market parastatals (and, in fact, other parastatals as well) were passed to the banks. Should the banks and other financial institutions be blamed for poor risk management—extending credit to finance losses? The answer is yes and no. It is yes, because the financial institutions are required by their statutes to operate on commercial principles—which means, among many other things, evaluation of loan

applications by traditionally acceptable banking methods and rejection of unprofitable risks irrespective of the nature of clients. It is no, because the major owner of the financial institutions—the treasury—issued guarantees for credit extended by the financial institutions to the parastatals, over and above the amounts that the banks were ready to extend on their own evaluations. In this way the banks were indirectly made to accommodate the parastatals' sector losses. In June 1988, of the total outstanding credit to marketing parastatals of shs. 24,017 million, 56 percent, or shs. 13,643 million, was considered unrecoverable or having been used to finance losses. This amount was mainly on account of the grain marketing parastatal (the NMC), the Tanzania Cotton Marketing Board, and the Tobacco Processing and Marketing Board.

Concluding Observations

Among the many things suggested by the analysis of this chapter, perhaps the most essential is that improvements in the efficiency of the financial system in Tanzania, and probably any other country, requires simultaneous (or prior) improvements elsewhere. More specifically, overall economic reform that creates a viable environment for the nonfinancial economic entities that constitute the clientele of the financial system is essential to effective deregulation and reform of the financial system. Deregulation of the nonfinancial markets is crucial, therefore, to successful financial reform. Moreover, for financial deepening to take place, monetary stability—and hence anti-inflation tax policies—have to be pursued. For the latter to be realistically attainable, the authorities must strive to evolve a monetary policy framework under which various policy instruments will become effective for reducing or increasing domestic liquidity. It is therefore arguable that there is a two-way causality between the financial system and monetary policy. On one hand, the type of financial structure determines the effectiveness of monetary policy instruments. On the other hand, monetary policy plays an important role in the development of financial structures.

Discussion

Alan Gelb: These papers have provided a basis for a lot of questions. For example, considering fiscal deficits and their financing, what has been the role of foreign aid? Where foreign aid is reduced and inflation rises, countries are probably forced into monetary financing. It may also be necessary to proceed on a case study basis. Another point: What is the role of central banks in Africa? In a country like Brazil, where inflation rates approach 1,000 percent, there is no government fiscal deficit because the central bank generates its own fiscal deficit by implementing a variety of programs. One needs to research carefully, on a country-by-country basis. The question of what really is the role of the central bank in these countries is an important one.

The point about high inflation and loan losses is very interesting. But I would like to add a caveat. Given the nature of the banking system—the way the institutions work and the way they are supervised—there may well be a relationship between high inflation and lower loan losses because of the erosion of losses. The depositors pay a tax, and part of that tax goes to bailing out the banks. But with high inflation and controlled interest rates, we usually find a higher degree of credit direction to the banking system. Thus the institutions do not develop processes to screen borrowers themselves. As a result there is an intrinsically weaker system. One needs to bear in mind that the inflation rate environment will affect the way institutions work. Particularly in the more repressed systems, banks are inherently weaker in judging their own clients.

Concerning real interest rates, savings, and investment, I have just finished a study of thirty-four countries over twenty-one years, and you may be interested to hear the results. I concluded that there is little evidence that real interest rates in financial markets affect investment levels in countries (I chose investment rather than savings because that way I also included the impact of foreign savings). But there is apparently some evidence, quite strong in my study, of a relationship between the incremental output capital ratios and levels of interest rates and very little relationship between those and inflation rates. The conclusion I came to was that this was a question of the efficiency of resource use, not of how much investment took place. Others have done other studies.

Countries like Tanzania, Somalia, Uganda, Mozambique, and Angola have much to learn from the efforts at financial liberalization elsewhere, in Algeria, for example, or Yugoslavia. At what stage does one want to introduce competition into a system like this? We have debated this ourselves for a number of countries. One very important question for China was whether the authorities in China should direct that financial institutions compete. We came to the conclusion that, given the other factors involved, in particular the large share of lending that was still directed and the absence of proper bankruptcy laws and proper supervisory systems, one had to go very carefully in promoting competition.

J. O. Sanusi: I would like to speak briefly on the paper presented by Mr. Greene. In the introduction to his paper, he mentioned a handicap that I think is a very real one in the African context: the inadequacy of data available for analysis of the type that he provides. One is advised to understand the paper's conclusions in this context of inadequate data. My own experience in the management of the Nigerian economy does not correspond with the author's analysis of the relationship between fiscal policy, monetary policy, and their effect on inflation.

I think he concludes that there appears to be no direct relationship between the rate of inflation and the level of the fiscal deficit. To prove this Table 8.3 provides a series of data that, looking at it, will fully support that conclusion. But one or two things that are absent from Mr. Greene's analysis could jeopardize the validity of his conclusions. For instance, it has to be understood that the rate of deficit financing has a much larger base than, for example, does the rate of money supply.

Then, what he refers to as the impact of the fiscal deficit is actually the consequence of the *method of financing* of the fiscal deficit. A budget deficit financed by the nonbanking sector has different consequences from one financed by the banking sector, and financing by the central bank produces still other results.

Because of the inappropriate interest rate structure, the inadequate development of the monetary system, and a lack of budget discipline by

many of the governments, most of the deficit financing in African countries is financed by their central banks. And deficit financing through central banks with high-powered money invariably results in inflation, a consequence of money's being pumped into the system without a corresponding increase in production of goods and services. It is nothing other than inflation.

Mr. Greene's paper lists quite a number of causes of inflation. But another cause of inflation, the low productivity of capital itself, is very clearly set out in the paper presented by my colleague from Tanzania. Particularly with the capital expended by government, a great deal of money is going out while low productivity and high inefficiency of the system continue, ensuring the inadequacy of goods and services. A growing money base, then, that has little correspondence with an increased quantity or quality of goods and services is necessarily inflationary.

Commenting on the paper by my colleague from Tanzania, I think quite a number of Mr. Kimei's observations are true of my own country, although the economic structure in Tanzania is basically different from the structure in Nigeria. I know that private sector participation is much higher in Nigeria than in Tanzania. In addition, several things that we have done in Nigeria are being phased out because of our ongoing economic restructuring—things like the subsidy resulting in increased deficit financing that in the past led to the central bank's putting high-powered money into the system, in addition to the amount of the budget deficit. I would welcome some clarification by Mr. Kimei of the method of deficit financing in Tanzania, especially because of the differences in fiscal budgeting between that country and Nigeria.

He mentions that there is less regulation in the banking sector than in the nonbanking financial sector. This is contrary to my experience. I would like to know how this could come about. The regulation of the banking system is usually very strict, and except for a few nonbanking financial institutions like the insurance companies, all others are virtually left free, with many finance companies not making returns or submitting reports to anybody.

Nancy Benjamin: I was also going to suggest looking at foreign loans and foreign capital flows. I am curious if either of you looked at or if there are any data on the composition of any of the price indices. Mr. Greene's paper noted that import prices did not seem to be moving with the overall price levels. I wonder if there is any particular structure to the pricing for certain kinds of goods that are rising faster than others.

Clark Leith: In reference to the explanations for inflation, we need to be a little bit more careful about grouping together really heterogeneous situations. What we have across Africa are many different kinds of situations. Each country is not simply a small open economy. There may be a

few small open economies in Africa, but most of the small economies are not open, and most of the large economies may be open, but there are many parts of them that are closed.

The way I try to think of the inflationary problem is to think of the many different markets that exist within the country and consider what is happening in those different markets. In some sectors we may find a situation where the price level will be explained by the small open economy assumption; hence the foreign prices and the exchange rate would basically determine the price level. In other words, it would be virtually free importation in those sectors. In other sectors we are looking at strictly administered prices backed by government subsidies or taxes. So that if we tried to explain what is going on in those sectors, we have to understand the government decision-making process rather than any excess demand kind of explanation.

In other sectors there is strictly limited supply, such as the licensed import sector, where excess demand is the explanation of inflation. Then we have to understand the linkages among all those and the labor market, how the labor market interacts with those, the input-output relationships. Finally, there has to be some sense of feedback to demand in all those markets. And in adding up all that, we have to have some understanding of how those different components weigh in in the inflation process.

Looking at it that way does not suggest that we are looking for any single explanation of whether the true answer for explaining inflation in all of Africa is fiscal deficits. I do not think that is a relevant question. It may be relevant in a particular instance, but to understand the way a given economy functions, we have to follow much more of a microbuildup approach.

Patrick Honohan: I would like to add a comment on this question of the linkage between fiscal deficits and inflation.

When one is talking about one country or perhaps even a number of homogeneous industrial countries, maybe it is reasonable to ask these sorts of questions and run horse races between them, asking, Is it fiscal deficit that causes inflation or is it monetary expansion? But when we think about it, the link between fiscal deficits and monetary pressure of one sort or another across countries is very different, depending on the various techniques of pressure that the government has adopted.

There are a number of examples in Africa that are, or are becoming, fairly well known. In Sierra Leone, for example, one of the main pressures that the government imposed on the financial system was through a nonclearing overvalued exchange rate, so that exporters were taxed through the imposition of this false exchange rate. When that tax was removed by liberalization of the exchange rate, then, short of a fiscal contraction, there had to be some other pressure imposed, and the natural

place to impose it was somewhere else in the financial system; this pressure took the form of base money creation, which led to inflation.

In Zambia it may be that a very similar thing occurred. It liberalized interest rates and discovered that the benefit of low interest rates was no longer flowing to the government (which had been borrowing at these low interest rates). Again there was pressure, and again it came out in the form of a monetary base expansion.

So maybe—and this is the approach that I have been trying to adopt—we should not just look at inflation as the outcome and examine what causes inflation so much as look at the overall sources of financing of the government deficit coming from the monetary and financial sectors. This may, in fact, be a more constant variable across countries and over time, as it is so difficult to change the amount of tax that is collected from the formal sectors.

Lawrence White: Following up on this question of differences between monetary regimes in different countries, I was wondering if Joshua Greene could draw out whether he finds any differences between franc zone countries and non–franc zone countries. The sort of naive view that economists have of an exchange rate regime supposedly practiced in franc zone countries is that the inflation rate in those countries should not be any greater than the inflation rate in France, but clearly that is not true, and I wonder if you could discuss why it is not true.

Patrick Honohan: I just pass on this question that I keep getting asked: We have high inflation in our country. You want us to liberalize interest rates. How can we deal with interest rates of 50, 60, 70 percent? In normal financial markets, we deal with bank loans and so forth. I have the stock answer I give, but I am never satisfied with it.

Kerfalla Yansane: On the issue of the relationship between monetary policy and fiscal policy, the fight against inflation in program adjustment is a long-term problem. In Guinea, for example, we have a very weak fiscal policy; so the whole adjustment program applies on monetary policy and what we do first on the exchange rate. We are obliged to move and to move very quickly.

Second, we also have to move on the interest rate in order for it to be close to the rate of inflation.

Third, we have to free prices so that people will import goods from abroad and are free to set prices in order that we might have high prices, a high exchange rate, and a high interest rate. But these consequences are a great concern. That is why we do not agree always with the International Monetary Fund. It wants these changes quickly, in the short term.

I believe that in an adjustment program, the fight against inflation is a long-term question because fiscal policy cannot be solved in twelve or fifteen or eighteen months. In Guinea, for example, because of twenty-five

years of socialism, people were not accustomed to paying taxes for the use of telephones or the receipt of water. Everything was "free." Now we try to apply a truth policy, and it is very difficult.

Donald Mathieson: Given my Latin American background, I find it interesting that in the discussion of monetary policy and interest rates, there has been no mention of the issue of capital flight and whether the accumulation of foreign currency or the removal of assets abroad is a significant problem, especially in the higher-inflation countries.

Joshua E. Greene/C. S. Kimei

Responses

Joshua E. Greene: Thank you all for some very stimulating comments. I have not yet looked at the role of foreign capital inflows. We may be able to do that with the World Economic Outlook (WEO) data base, and I will see if I can, as it were, throw that into the pot.

For those of you who raised the question of financing deficits as opposed to deficits per se, I could not agree more. The problem thus far has been pinning down those data in the data base that I have.

With enough time each African desk officer could provide for a time series on financing of fiscal deficits. Unfortunately, I did not have that time, and in the WEO data base I have available, it is a little bit harder to tease that out, but I assure you, I am looking into it. Indeed, I had pointed out in the talk and to a lesser extent in the initial draft of the paper that what we find about the fiscal deficit per se does not mean that deficits do not matter. It may mean that it is the financing of deficits that matters. This is what we are examining now (and is confirmed in the revised draft of the paper that appears in this book).

Data for the components of price indices could be identified, with enough time to do a country-by-country analysis, since the IMF has detailed data about the prices indices of individual countries. I would point out that in the bulk of the African countries a very large component of the overall consumer price index comes from food. Therefore, there may not be as clear a transmission mechanism, say, from the foreign factors into the consumer price index as one might like.

There are countries, however, such as Uganda, where there may be a direct transmission from exchange rate adjustments even to food prices, since the price index reflects only prices in the capital city. So it might show up there. It is a tricky issue insofar as data are concerned.

I agree with people about the difficulty of drawing conclusions from an aggregate treatment as opposed to a country-by-country study. Nevertheless, given the time available and the data available, it seemed most useful to start at the aggregate level. It is very clear that conditions differ from country to country. As regards the question raised about the franc zone, it is striking that average inflation rates in these countries have not been as high as in the former English and Portuguese colonies.

It is clear, however, from the paper on the franc zone that we will hear later on this morning, that these countries have also had economic difficulties, even if their inflation rates have not been as high as in other countries. Indeed, because they have been tied to the French franc, their overall competitiveness has risen and fallen with that of the French franc, plus the effects of a steady 5 to 10 percent inflation. Over a long enough period of time, that can have some consequences for competitiveness in their economies, even if inflation rates in individual years are not as high.

The question about the small-economy model as opposed to looking at individual markets is again a question of being able to look on a country-by-country basis: I would certainly encourage others to do it. It does take time. Certainly one thing we could consider is whether it is worth having someone consult with the desk officers for individual African countries to collect data so as to do careful case studies.

There was a question about overall sources of government financing and the effect on the inflation rate of eliminating the hidden tax on exports arising from an overvalued exchange rate. This is a very provocative subject. Brian Pinto at the World Bank has written some interesting studies on this, drawing on the experience in Sierra Leone and, to a lesser extent, in Zambia. I have not looked into this question.

A final point I will touch on is the difficulty in making the case for interest rate liberalization in a high-inflation environment. The normal argument is that artificially low nominal interest rates create financial repression. Interest rates must be able to reflect the real scarcity value of money, but the transition to a higher interest rate environment will impose costs on some people. One has to be aware of that and possibly consider ways of dealing with it without continuing to repress price signals.

C. S. Kimei: In the case of Tanzania, as argued in both the text and one of the tables of my paper, it is clearly shown that the government, or more precisely the expanded public sector, has been the major cause of monetary expansion in the country. This accounts for my argument that much of the inflation problem in Tanzania is attributable to the fiscal deficits.

On the other question of capital flight, in Tanzania there was a time in 1983 when a campaign against economic saboteurs was conducted under the late Prime Minister Sokoine. A number of citizens and residents were found with very large sums of foreign currency, mainly Indians and businessmen who had international connections. These findings reflected the extent of capital flight, at a time when the country had severe foreign exchange problems. In recent years we have established an own-exchange scheme under which anyone can import anything so long as he has foreign exchange. The experience over the past two or three years has shown that a large proportion of imports is on account of own-exchange. It is yet to be known where the foreign exchange comes from. Imports on own-exchange increased to about $200 million in 1987–88, constituting about two-thirds of total export earnings. This simply suggests that there is either a lot of capital flight or a lot of money that would otherwise be sent abroad or kept in mattresses and pillows in foreign exchange. This is despite strict foreign exchange controls.

With respect to the question raised by my colleague from Nigeria about regulation of banks and the nonbank financial institutions, in Tanzania the statutes that established the commercial bank—the NBC—put very little restrictions on it. In fact, the commercial bank is subject to very few restrictions from the central bank. The latter has the power to impose restrictions aimed at effecting monetary controls, such as reserve requirements and interest rates. It cannot, legally, impose prudential requirements, such as capital adequacy ratios. The NBC, therefore, has enjoyed much less strict financial regulations than the nonbank financial institutions, which were restricted by statutes from going into the commercial banking business. My point here is that the nonbank financial institutions were restricted by their statutes in resource mobilization from the public. As a result a gradual decline occurred in their share in total financial assets.

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Patrick Plane

Financial Crises and the Process of Adjustment in the Franc Zone: The Experience of the West African Monetary Union

The West African Monetary Union (Union Monétaire Ouest Africaine—UMOA), together with the member countries of the Central Bank of the West African States (Banque Centrale des Etats de l'Afrique de l'Ouest—BCEAO), constitutes the African component of the franc zone. The UMOA currently consists of most of the nations in the region formerly known as French West Africa: Benin, Burkina Faso, Ivory Coast, Niger, Togo, Senegal, and Mali, which has the unusual distinction of having left the union in 1962 and rejoined it in 1984, after a transition period of sixteen years during which France was closely involved in the management of its issuing institution.[1]

Since the second oil crisis all the member countries of the union have been faced with considerable disequilibria in their balances of payments. Because of their size these deficits have surprised most observers, for whom the franc zone had, until recently, embodied an ideal of economic

development based on major macroeconomic equilibria. The aim of this chapter is to describe both the process whereby such deficits came into being and the steps taken to correct them.

The first section provides an overview of the UMOA's methods of operation. Sections two and three deal with the scope of the financial crises and the factors of internal economic policy that caused them. The fourth section analyzes the results of the processes of stabilization and structural adjustment. Section five summarizes the major themes of the chapter and touches briefly on the remaining problems.

The Wheels of Monetary Cooperation

Although the cooperation between France and its African partners extends to all fields, monetary relations attract the greatest attention because they are what is unique about the UMOA and the franc zone in general.[2] This cooperation is expressed in the affirmation of three major principles aimed at promoting economic development in a context of monetary stability:

1. A currency common to all the member countries of the union, the CFA franc. Its rate of exchange with respect to the French franc is fixed. The current parity, 1 CFA franc = 0.02 French francs, has not been adjusted since 1948. Modification of the parity is possible, but it requires the unanimous agreement of all parties concerned.
2. Community management of exchange reserves. The BCEAO keeps at least 65 percent of its official assets on deposit in an operating account opened on the books of the French treasury (and depicted in the Appendix to this chapter). The unusual thing about this account is that it can be overdrawn by any amount as a result of the commitment undertaken by France to convert the African currency regardless of the amount of foreign exchange holdings of its partners.
3. Free transfer within the zone, which cannot be violated, even if one of the countries is experiencing serious balance-of-payments difficulties.

The fact that the conversion guarantee applies only in the event of the depletion of all of the union's consolidated external assets merely implies that the BCEAO, through the Operating Account Agreement, is answerable only to the French treasury. This condition explains why the conversion guarantee did not come into play until December 1979, although Senegal and Benin had for several months been in a deficit position with regard to the issuing bank. It can be said, then, that the convertibility guarantee operates on two levels of intracommunity solidarity: first, African solidarity when the BCEAO operating account permits compensating for national positions on the debit side while remaining on the credit side itself; second, French solidarity whenever the international exchange reserves

are depleted. This distinction between two levels of solidarity is a dangerous one to make, however, because it can give the impression that before 1979 France's exchange guarantee was useless. The mere fact that it could be enforced at any time helped to maintain confidence in the African currency, which enabled the countries to increase their external debt options.

In exchange for the unrestricted convertibility of CFA francs, the African countries are encouraged to exercise a form of monetary discipline aimed at establishing a certain price stability, as well as activating a warning system when the external exchange assets appear to be in danger of becoming depleted.

With regard to the determination of an adequate money supply, each country has a National Credit Committee (Comité National du Crédit—CNC), which is responsible each year for establishing the money supply on the basis of gross domestic product price and volume growth projections and hypotheses of invariance of the ratio of money to the GDP (k) and the ratio (m) between the money supply and the currency in circulation (B). Given a projection of the variation of external assets (AEN) and the assistance to the government (CNG), the national committee determines the increase of net economic credit (C) that is compatible with monetary equilibrium.

$M^D = K \cdot P \cdot Y$ (demand for money equation)

$M^S = B + D = AEN + CNG + C$ (equation for the supply of money and its equivalents)

$M^S = m\,B$ (monetary equilibrium equation)

$M^S = M^D$

$C = M^D - AEN - CNG$ (equation for determining the total amount of credit in the economy)

Determined according to the principles of the quantitative theory of money, the overall monetary assistance to each economy is subject to the approval of the board of directors of the central bank, which may, if necessary, reduce it if the union's exchange reserves require replenishment. Besides determining the level of annual assistance, the BCEAO also has a full range of mechanisms enabling it at any time to make the necessary corrections to maintain monetary equilibrium. The principal mechanisms are the prior authorizations required of commercial banks for any credit above a certain amount granted to an enterprise, direct interventions in the money market (open market), and the possibility of establishing a system of compulsory reserves. In addition, the advances to each government are set at a maximum of 20 percent of the tax revenues of the preceding year. Although a similar limitation is included in the bylaws of

most of the central banks, thus marking the issuing institution's independence from the public authorities, the bylaw identifying the BCEAO as a public international establishment guarantees observance of this provision.

Concerning the warning system:

- Article 51 of the bylaws of the central bank provides that the board of directors shall meet for the purpose of taking every appropriate measure whenever the ratio of the bank's external holdings to sight liabilities reaches a level equal to or less than 20 percent for a period of at least ninety days.
- Article 20 of the treaty establishing the UMOA adds that in case of the depletion of liquid assets, the central bank must request transfer to it of the foreign currencies held by any agency under the jurisdiction of the union.

In general, it can be said that the BCEAO is theoretically provided with the means necessary to prevent large-scale monetary imbalances. On the basis of this observation, detractors of the franc zone have questioned the actual scope of the guarantee of unlimited convertibility of CFA francs. In fact, if the monetary discipline of the African partners is infallible, is not the overdraft of the operating account a figment of the imagination (Martin 1987)? The experience of the past ten years removed any doubt on this subject once and for all.

The Deterioration of Balances of Payments in External Financial Crises

Although the union was constantly in the red in trade in foreign energy products, the first oil crisis had no significant effect on the balance of consolidated international payments. For the period 1973–1978, there was a surplus in the aggregate balance of approximately 50 million SDRs (Special Drawing Rights), the consequence of which was to build up exchange reserves and thus to improve the credit position of the operating account. This performance must be examined in greater detail, however (Tables 10.1 and 10.2).

- Most of the states launched into a highly active external debt policy that considerably increased the vulnerability of their economies to fluctuations in the foreign environment. A tangible result of this policy was that investment and consumer expenditures rose sharply and, along with them, the current account deficit, the cumulative total of which reached 2 billion SDRs, or about 80 percent of the union's average annual exports between 1973 and 1978.
- Analysis by country reveals highly varied trends (Table 10.3). Until 1977 the Ivory Coast position remained satisfactory, in part because of the

freezing of Brazilian coffee plants. This favorable international situation led to a sharp increase in world coffee prices and a considerable improvement in the Ivory Coast's external terms of trade. Conversely, Senegal and Togo were faced with serious financial imbalances even before the second oil crisis occurred.

As in the case of the Ivory Coast but four years before the boom in major primary commodities exports, it was the foreign environment that precipitated the deterioration of the economic and financial position of these countries. In two cases the state had to deal with the collapse of world phosphate prices after a brief period of considerable increases. The economic consequences of the price collapse were disastrous because of poor planning on the part of the governments. The flow of tax revenues occasioned by the boom was in fact managed as though it were permanent; hence the upswing in investment programs and budget expenditures in general, accompanied by increased access to external debt. When prices suddenly plummeted, the tax revenues diminished rapidly, and the prospects of external financing narrowed, while expenses remained abnormally high. This asymmetry of growth placed heavy strains on public finances.

The factors that led to the crisis in the economies of Senegal and Togo are also interesting because they illustrate a process of blockage caused by the public sector's lack of cash and not by the lack of foreign exchange, as is generally the case in developing countries outside the franc zone.

In 1978 the treasury of Togo was unable to honor all its obligations. Having reached the ceiling on cash advances from the central bank and unable in the short term to give the necessary flexibility to revenues and budget expenditures, the government, for the first time, fell behind in its payments. Meanwhile the private sector made it possible for the economy to accumulate new foreign exchange holdings. In Senegal the same scenario unfolded, with the slight difference that the cash flow problem came later. Until 1980 the authorities were able to meet all their external obligations, but Senegal's position in the operating account became negative in 1978.

With the deterioration of the international environment after the second oil crisis and the increased debt service burden, in 1979 the UMOA entered a phase of increasingly severe external crisis. Table 10.1, on which the following commentary is based, was prepared to show the volume and structure of the resources mobilized to finance the imbalances. The step taken by the monetary union conformed to the regulations of the International Monetary Fund, as set forth in the *Balance of Payments Manual* of 1977, but warrants the elaboration of two additional comments.

First, callable payments were discussed. Since the balances of payments of the union are generally prepared and published on the basis of payments

TABLE 10.1

Evolution of Compensatory Financing of the West African Monetary Union, 1970–1985 (millions of SDRs)

	1970–1972	1973–1978	1979–1985	1983–1985
Current balance	−297.3	−2,222.5	−10,176.4	−2,380.2
Basic balance	62.4	−37.6	n.a.	n.a.
Aggregate balance	24.7	48	−4,842.8	−2,175.8
Compensatory financing (CF)	−24.7	−48	4,842.8	2,175.8
Variations in foreign exchange holdings	−58	−287.5	7.8	−241
Operating account overdrafts	0	0	686.9	−27.8
Net position vis-à-vis the IMF	−14.6	106.5	1,054.5	261.7
Structural adjustment loans and nonproject loans:				
World Bank	0	0	462.5	296.6
CCCE	0	8.9	442.1	232.5
Restructuring of external debt	0	0	1,735.5	1,403.9
Outstanding external payments (arrears)	0	33.1	389.2	199.1
Miscellaneous	47.9	91.0	64.3	53.7
Compensatory financing (%)	100	100	100	100
Variations in foreign exchange holdings	234.8	599	0.2	−11.1
Operating account overdrafts	0	0	14.2	−1.3
Net position vis-à-vis the IMF	59.1	−221.9	21.8	12.0
Structural adjustment loans and nonproject loans:				
World Bank	0	0	9.6	13.5
CCCE	0	−18.5	9.1	10.7
Restructuring of external debt	0	0	35.8	64.5
Outstanding external payments (arrears)	0	−69.0	8.0	9.2
Miscellaneous	193.9	−189.6	1.3	2.5

As a percentage				
Average of annual export compensatory financing ratios	−6.1[a]	−0.1[a]	13.8	17.1
Cumulative compensatory financing/average exports	−2.2[a]	−1.8[a]	106.1	46.6
Note (average for the period)				
Exports of goods and services	1,127.8	2,720.7	4,563.2	4,667
Imports of goods and services	1,370.4	3,374.7	5,690.5	5,095
Gross reserves	258	331.4	362	434
Gross international reserves in import days	69	36	23	31

NOTE: The aggregate balance is defined as the balance of all the autonomous operations.

n.a. = not available.

a. The minus (−) sign indicates an overall payments surplus.

SOURCE: IMF, *Balance of Payments Yearbook Statistics* (various years); *International Financial Statistics*, 1986 Yearbook; *Recent Economic Development* (various years); unpublished data: World Bank and Caisse Central de Coopération Economique (Central Economic Cooperation Fund) for structural adjustment loans and nonproject loans; Banque de France for the operating account.

TABLE 10.2

Evolution of Compensatory Financing in the UMOA by Country and by Period, 1970–1985 (in millions of SDRs and as a percentage)

	Benin				Burkina Faso				Ivory Coast			
	1970–1972	1973–1978	1979–1985	1981–1985	1970–1972	1973–1978	1979–1985	1983–1985	1970–1972	1973–1978	1979–1985	1983–1985
Current balance (CA)	−7.4	270.3	−987.4	−251	12.2	−192.9	−407.9	−202.1	−230.6	−1,589	−5,443	−855.6
Basic balance	17.2	−184.1	−345.6	−206	11.4	−77.9	n.a.	n.a.	−37.7	373.3	−2,993	−1,122
Aggregate balance	14.1	−36.3	−256.5	−204.7	16.5	−23.6	−51.2	−1[illegible]5	−51.2	188.8	−2,896	−1,283.5
Compensatory financing (CF)	−14.1	36.3	256.5	204.5	−16.5	23.6	51.2	[illegible]	51.2	−188.8	2,896	1,283.5
Variations in foreign exchange holdings	−13.5	14.3	9.4	0.3	−11.8	16.1	−75.5	−38.2	16.9	−273.6	323.1	−4.3
Operating account overdrafts	0	0	67.6	46.2	0	0	0	0	0	0	366.8	−163.2
Net position vis-à-vis the IMF	−0.7	5.5	13.1	3.1	−1.7	3.8	3.9	−4.2	−9.3	31.7	648.5	142.1
Structural adjustment loans and nonproject loans:												
World Bank	0	0	0	0	0	0	0	0	0	0	161.1	240.2
CCCE	0	0	0	0	0	0	24.6	8.6	0	0	376.1	108.7
Restructuring of external debt	0	0	0	0	0	0	0	0	0	0	929.8	929.8
Outstanding external payments (arrears)	0	0	166.3	155	0	0	77.1	52.0	0	0	0	0
Miscellaneous	0	16.5	0	0	−3.0	3.7	21.2	15.4	43.6	53.1	90.8	30.2

Compensatory financing (CF) (%)	100[a]	100	100	100	100[a]	100	100	100	100	100[a]	100	100
Variations in foreign exchange holdings	95.7	39.4	3.7	0.1	71.5	68.2	−147.5	−114.0	33.0	144.9	11.2	−0.3
Operating account overdrafts	0	0	26.4	22.6	0	0	0	0	0	0	12.7	−12.7
Net position vis-à-vis the IMF	4.3	15.2	5.1	1.5	10.3	16.1	7.6	−12.5	−18.2	−16.8	22.4	11.1
Structural adjustment loans and nonproject loans:												
World Bank	0	0	0	0	0	0	0	0	0	0	13	18.7
CCCE	0	0	0	0	0	0	48.0	25.5	0	0	5.6	8.5
Restructuring of external debt	0	0	0	0	0	0	0	0	0	0	32.1	72.4
Outstanding external payments (arrears)	0	0	64.8	75.8	0	0	150.6	155	0	0	0	0
Miscellaneous	0	45.4	0	0	18.2	15.7	41.4	46	85.2	−28.1	3.1	2.4
Average of annual export compensatory financing ratios (%)	−6.2	4.6	19.3	36.6	−17.0	−2.5	4.0	6.1	2.6	0.3	15.8	16.4
Cumulative compensatory financing/average exports for the period (%)	−17.7	29.9	135.9	105.8	47.0	28.1	30.1	18.9	8.6	−11.5	106.4	44.8
Note												
Exports of goods and services (%)	79.7	121.3	188.7	193.3	35.1	84	170	177.6	596.6	1,635	2,721	2,868
Imports of goods and services	108.3	205.0	318.4	259.0	87.1	230	445	433.0	653.2	1,717	3,666	2,910
Gross reserves	22.1	19.2	11.5	3.0	41.0	54	76.7	106	96	132	24.9	9.4

(continued)

TABLE 10.2
(continued)

	Benin				Burkina Faso				Ivory Coast			
	1970–1972	1973–1978	1979–1985	1981–1985	1970–1972	1973–1978	1979–1985	1983–1985	1970–1972	1973–1978	1979–1985	1983–1985
Petroleum products balance	−2.9	na	na	na	−4.3	−10.5	na	na	−21.3	−75	−168	−74.4
Investment earnings balance	0.7	na	na	na	1.4	2.7	−1.5	−4.1	−9.5	−53.8	−383	−493
Gross international reserves in import days	74	42	12	5	174	97	63	89	54.5	26	3	1

	Niger				Senegal				Togo			
	1970–1972	1973–1978	1979–1985	1981–1985	1970–1972	1973–1978	1979–1985	1983–1985	1970–1972	1973–1978	1979–1985	1983–1985
Current balance (CA)	−27.4	−264.3	−874.1	−156.3	−31.7	−536.5	−1,996	−802	−12.6	−227.3	−468	−113.2
Basic balance	59.4	55.4	−279.8	−102.6	19.7	−191.8	−931.4	−219.9	−7.6	−12.5	−583.5	−217.5
Aggregate balance	26.8	47.7	−185.4	−78.4	16.4	−116.8	−1,069	−448.8	2.1	−11.8	−384.5	−126.3
Compensatory financing (CF)	−26.8	−47.7	185.4	78.4	−16.4	116.8	1,069	448.8	−2.1	11.8	384.5	126.3
Variations in foreign exchange holdings	−26.3	−57.6	−26.6	−78.0	−22.2	23.3	−0.1	1.1	−1.2	−21.0	−222.5	−121.9
Operating account overdrafts	0	0	0	0	0	11.1	252.5	89.7	0	0	0	0
Net position vis-à-vis the IMF	−0.7	2.5	71.7	33.4	−1.3	56.1	240.7	44.8	−0.9	6.9	77.2	42.5

Structural adjustment loans and nonproject loans:												
World Bank	0	0	0	0	0	0	54.3	0.3	0	0	52.1	52.1
CCCE	0	0	57.3	22.2	0	0	163.9	69.5	0	0	35.2	23.5
Restructuring of external debt	0	0	100.1	91.8	0	8.9	357.3	217.3	0	0	348.3	164.9
Outstanding external payments (arrears)	0	0	0	0	0	0	28.4	26.0	0	0	117.4	−33.9
Miscellaneous	0.2	7.4	−16.5	9	−7.1	17.5	−8.0	0	0	−7.2	−23.2	−0.9
Compensatory financing (%)	100[a]	100	100	100	100[a]	100	100	100	100[a]	100	100	100
Variations in foreign exchange holdings	98.1	57.6	−14.3	−99.5	135.4	19.9	0	0.2	57.1	−17.8	−57.9	−96.5
Operating account overdrafts	0	0	0	0	0	9.4	23.6	20.0	0	0	0	0
Net position vis-à-vis the IMF	2.6	2.5	38.3	42.6	7.9	48.9	22.5	10.0	42.9	58.5	20.1	33.7
Structural adjustment loans and nonproject loans:												
World Bank	0	0	0	0	0	0	3.2	0.1	0	0	13.6	41.3
CCCE	0	C	30.9	28.3	0	7.6	15.3	15.5	0	0	9.2	18.6
Restructuring of external debt	0	0	54.0	117.1	0	0	33.4	48.4	0	0	90.6	130.6

(continued)

TABLE 10.2
(*continued*)

	Niger				Senegal				Togo			
	1970–1972	1973–1978	1979–1985	1981–1985	1970–1972	1973–1978	1979–1985	1983–1985	1970–1972	1973–1978	1979–1985	1983–1985
Outstanding external payments (arrears)	0	0	0	0	0	0	2.7	5.8	0	280.5	30.5	−26.8
Miscellaneous	−0.7	7.4	−8.9	11.5	4.3	15.1	−0.7	0	0	−61.0	−6.0	0.7
Average of annual export compensatory financing ratios (%)	−12.9	−4.1	7.5	10.3	−2.1	2.1	20.8	19.3	−0.9	0.2	15.3	13.9
Cumulative compensatory financing/average exports for the period (%)	−37.0	−29.4	46.9	22.5	−6.2	21.3	144.3	57.6	−0.7	6.9	110.5	41.8
Note												
Exports of goods and services (%)	72.5	162.3	395	347.9	265.5	547.5	740.6	778	78.5	169.9	347.9	302
Imports of goods and services	92.1	270.3	570	442	328.0	711.6	766.3	624	101.6	240.3	487.6	426.7
Gross reserves	30.1	64	83.6	90.2	0	18	8	7	40	44	14	217
Petroleum products balance	−3.9	−13.7	−70.9	−58.9	−5.8	−32.7	−110	−120	−3.5	−12.5	−28.4	−16.6
Investment earnings balance	0.5	−1.8	na	na	−2.1	−14.0	−72	−99.8	−1.1	−3.5	−31.8	−42.6
Gross international reserves in import days	39.6	75	57	77	30.3	9	4	4	143.7	81.8	118	186

a. Aggregate payments surplus.
SOURCE: Same as Table 10.1.

TABLE 10.3
Evolution of Major Export Prices, 1973–1983

Country	Products	Boom period	Price multiplier coefficient[a]
Ivory Coast	Coffee	1976–79	1.45
	Cocoa	1973–74; 1977–79	1.47; 2.42
Niger	Uranium	1975–83	3.5
Senegal	Phosphate	1974–75	3.05
	Peanut oil	1974	1.49
Togo	Phosphate	1974–75	3.05

NOTE: n.a. = not available.
a. Average prices during the worldwide boom as compared to the average prices for the 1970–1972 period.
SOURCE: World Bank, *Price Prospects for Major Primary Commodities*, 1984.

made, it was necessary to reconstruct the accounting documents to include in the deficit certain transactions that were not recorded because they did not involve disbursements (including, for instance, the results of the rescheduling of debts and variations in outstanding external payments).

Second, it was thought proper to include in compensatory financing certain long-term loans reserved exclusively for countries that had successfully restored their balance of international payments. This thinking was consistent with the conception of compensatory financing as including all the sources of financing for correcting the disequilibrium in the balance of payments. The special mechanism of the compensatory financing of export earnings managed by the IMF is only one possible component of this kind of financing. The same is true of World Bank structural adjustment loans and nonproject loans but also, on the bilateral plane, of assistance of the same type that the French government was able to provide through the operations of the Central Economic Cooperation Fund (Caisse Centrale de Coopération Economique), whether under the heading of structural adjustment loans or sectoral loans.

For the 1979–1985 period, the amount of the consolidated overall imbalance in the union's international payments is estimated at nearly 5 billion SDRs, or more than 100 percent of the average exports of goods and services for the period. The cumulative deficit in current transactions was even more astonishing since, using the same denominator, the percentage was 220 percent. Although all the financing mechanisms were called into play, their relative importance was modified as time passed, according to a strategy that duplicates the way crises are managed in most developing countries. In other words the financing of deficits was at first dominated by unconditional facilities such as drawings on foreign exchange holdings

and, in this case, in 1979 and 1980, the use of the special facility of overdrawing the operating account.

The fact that the crisis in external payments and public finances affected several countries called for a large-scale mobilization of various types of conditional assistance from the IMF and the World Bank during 1981–1983. With regard to the assistance from the fund, this mobilization was effected to enable the BCEAO to interpret its bylaws in a less stringent manner. In 1981, in fact, the central bank allowed public treasuries to obtain the counterpart in national currency of their drawings, independently of the cash advance ceiling of 20 percent of the tax revenues of the preceding year (Goreux 1985). This relaxation had become necessary. Without it, it is difficult to see what motivation the member countries would have had to negotiate programs with the IMF since, under the system of exchange of CFA francs, the external payments crisis could only have been caused by a scarcity of available funds at the state level.

Some observers, however, expressed disapproval, saying that this measure tended to give more weight to the state and, in the medium term, mortgaged the recovery of the union's external position in conjunction with the phase of repurchasing national currency. These concerns are no doubt justified. But, as will be seen in the following section, the situation before the programs was misleading and was characterized by a de facto lifting of ceilings together with growing external debt and, subsequently, overdue payments. The need to solve the cash flow crisis of the public treasuries forced such an initiative on the BCEAO. And to the extent that, in exchange for drawing rights, the member states were required to implement stabilization policies—including a program for retiring overdue public debt, strict control of external loans and economic credit, and a more satisfactory distribution of monetary resources between the public sector and the private sector—then it can be said that the resources of the fund made a very positive contribution to alleviating the financial crisis while at the same time promoting economic reform.

Finally, as a result of fewer possibilities of drawing on the various credit facilities of the fund and the continuing problem of external debt, rescheduling became crucial in 1984 and 1985. Since all dealings with the financial clubs of Paris and London are conditional on the signing of a confirmation program with the IMF, it can be said that the withdrawal of the institution as a direct provider of resources was largely offset by the lever or financial catalyst effect of each agreement.

In the preceding general commentary, it was implicitly assumed that in the 1979–1985 period the union constituted an economic unit characterized by uniform behavior with respect to the policy of financing the balance of payments. In reality, this assumption requires a certain degree of qualification, as is evident in Table 10.2.

Not all the countries were simultaneously affected by the financial crisis with the same intensity. Togo (in 1977) and Senegal (in 1978) were hit by the crisis even before the second oil crisis erupted, which was not the case for Niger, where the strains on the balance of payments did not become apparent until the fall in uranium prices in 1982. As for the Ivory Coast, given its central position in the union, it is not surprising that its financial position directly influenced that of the UMOA.

Although all the countries were affected by the financial crisis, not all of them adopted the strategy described above. In fact, Benin and Burkina Faso have so far rejected any adjustment program connected with the IMF. This refusal has made access to all balance-of-payments assistance impossible. The result of this has been to worsen the financial freeze, with a locking up of external accounts that can only be brought about by mounting internal and external payment arrears.

The Internal Origins of the Deterioration of External Accounts

The weakening of the balances of payments was due to a number of factors. In the preceding section a brief account was given of the impact of the international environment, particularly as it related to the instability of foreign terms of exchange and, beginning in 1979, the growing debt service burden resulting partly from rising interest rates. This section focuses on the responsibility of local economic measures and the riskiness of monetary and budgetary policies.[4]

On the monetary plane circumstances necessitated that the reform of the UMOA take place in the midst of the oil crisis (1973–1975). In theory this reform was to result simultaneously in decentralization of the monetary authority and reinforcement of the regulatory powers of the central bank, whose means of intervention were at that time expanded. In the specific international context of the 1970s, these two objectives proved to be virtually incompatible.

Through the national monetary committees responsible for determining the volume and distribution of credit according to the procedures briefly described in the first section of this chapter, the governments adopted expansive monetary policies motivated by a desire to give money a more active role than it had had in the past in the promotion of economic development. (This objective was raised again when the Council of Ministers of the UMOA resolved to implement the reform of May 2, 1975.) The implementation of these policies demonstrates implicitly that the authorities agreed with certain critical observers of the franc zone that the monetary stability of the 1960s had been achieved at the expense of economic growth. In any case when, between 1975 and 1978, the net

foreign exchange holdings of the UMOA increased in conjunction with a positive trend in the terms of trade, the expansion of internal credit was procyclical, contributing to a rapid increase in the money supply, the average annual growth rate of which went from 14.5 percent between 1967 and 1973 to almost 30 percent in the 1973–1978 period.

When, despite this, more lively economic growth did not occur, the result of this policy was to place strains both on local prices and on the union's external position. The central bank could have tried to temper the boldness of the national monetary committees by neutralizing, through the growth of the internal counterparts of the money supply, the expansive effect of unexpected temporary booms on the primary commodities markets. But such a step would risk thwarting the desire to forge closer ties between money and economic growth and might have been misunderstood by the states, inasmuch as neither the level nor the variation of the union's foreign exchange holdings justified slowing down the rate of growth of the money supply.

As circumstances would have it, the strains on foreign exchange holdings did not become apparent before the third quarter of 1979. In this context the BCEAO resigned itself to a laissez-faire attitude. This attitude of the central bank was criticized. The bank's method of monetary programming was also criticized for being excessively influenced by the momentary level of the union's reserves and, therefore, too far removed from the consequences of economic policies on the medium-term growth of those reserves (Krumm 1987). Although this criticism is justified, there is no proof that those involved would not have reacted to a tightening of internal credit by increasing their external debt. Indeed, it has been observed that the effectiveness of the BCEAO's monetary control is asymmetrical, being most limited when the facilities for external debt are greatest (Bhatia 1985).

In December 1979 the foreign exchange holdings of the central bank fell below the threshold of 20 percent of sight liabilities. Thus the BCEAO was again in a position of being able—if not compelled—to impose more restrictive monetary policies. At first, however, such measures were only diffidently applied as the central bank used all the latitude accorded it by Article 51 of its bylaws. Although, according to the bylaws, the board of directors is required to take every necessary step to improve the external position, it freely determines the means and the strength of its action. This moderately restrictive policy was dictated by the desire to cause only a gradual decline in liquidity ratios. A too sudden drop in these ratios would have involved tenuous liquidity positions and cash problems for everyone, including the banking systems. Unfortunately, the effect of this policy was not sufficient to check the development of illiquidity crises and the accumulation of arrears.

With regard to budgets, as mentioned in the analysis concerning the institutional mechanisms of the UMOA, cash advances to public treasuries

are limited by the bylaws to 20 percent of the tax revenues of the preceding year. This limitation, which is supposed to protect against drifts, was in fact circumvented in a number of ways. The four main ones are identified in the following paragraphs.

First, for a long time the credit granted to public enterprises had been lumped together with private sector credit in the BCEAO accounts. This being the case, as soon as the states encountered cash problems, the immediate solution was to encourage these enterprises to indebt themselves to the local banking system to compensate for an absolute reduction in operating subsidies or capital endowments. In practice this tendency to use substitute sources of financing was all the less problematic since the states are majority shareholders in most of the commercial banks and the latter are in any case placed under the influential supervision of the Finance Ministry.

Second, without violating the 20 percent rule for advances from the central bank, the states were able to finance budgetary deficits by taking advantage of external loans. Rattan Bhatia (1985) has suggested that this system of placing a ceiling on advances was ultimately a factor in overindebtedness. This assertion must be viewed with reservations, however, because without any regulation in this matter, two scenarios would have evolved, both demonstrating that external loans were finally necessary to finance expansive economic policies. In fact, either the states would have had to resort to internal money creation even more vigorous than that observed, which would have made the strains on foreign exchange holdings apparent well before 1979, forcing the BCEAO to implement restrictive monetary measures earlier; or, for an equivalent growth of monetary resources, the states would have been compelled to ration internal credit to the private sector. The effect of crowding out the private sector with respect to internal credit would have been compounded by its resulting loss of access to international financial markets.

Third, in certain states seasonal credits, which are intended to facilitate the process of producing and marketing agricultural products and for which there is no ceiling, were used for other purposes. Logically, in fact, these credits are reversed within the year. The trend observed toward an increase in their amount shows that this was not always the case. The example most often cited is that of the National Office of Cooperation and Assistance for Development (Office National de Coopération et d'Assistance pour le Développement—ONCAD). A semipublic institution, ONCAD was consistently able to finance operating deficits caused by the cumbersomeness of its structures with seasonal credits, which the agency was of course unable to repay on time (S. Guillaumont 1984, Goreux 1985).

Fourth, the accumulation of payment arrears by most of the public treasuries was one way of financing budgetary imbalances, with the negative consequences for the overall functioning of the economies that

one might expect. These arrears caused not only carryover effects but also imitation effects on the part of the other internal economic units (de Boissieu 1985).

Membership in the Monetary Union and the Implementation of Adjustment Programs

Because of the community management of the exchange reserves, a country with a temporary disequilibrium in its balance of payments has every chance of being able, regardless of the nature and the size of the deficit, to avoid the burden of a socially costly and economically useless stabilization. In the presence of a persistent external imbalance, however, the principle of community management becomes more questionable since it can enable delays in the implementation of structural adjustment programs.

When the balance of the operating account is positive, through the action of compensations between national exchange positions, a country whose position is negative can in fact delay the adoption of corrective measures. No provision of the bylaws compels it to restore the balance of its international payments or to replenish its foreign exchange holdings.

When the balance of the operating account becomes negative, the institutional mechanism obligates the central bank to adopt monetary measures necessary to correct the foreign exchange holdings position. Nonetheless, the room for maneuver of the BCEAO is great since access to overdrawing the operating account requires no formal agreement or any involved negotiations on the content of adjustment programs.

Be that as it may, it does not appear that the overdraft facility was used to circumvent the exigencies of adjustment. Although the operating account actually provided most of the compensatory financing in 1979 and 1980, the countries falling prey to more serious difficulties (with the notable exceptions of Benin and Burkina Faso) availed themselves of the conditional assistance of the IMF in the first few months after their positions became negative. Given that access to the overdraft facility is automatic and immediate whereas establishing a program with the IMF is preceded by frequently lengthy and difficult negotiations, the time lag is not indicative of political reservations about adjustment. Thus there was a relationship of complementarity rather than of substitution between these two sources of compensatory financing.

Beginning in 1983 stabilization and structural adjustment policies produced spectacular results, as displayed in Table 10.4. Expressed as a percentage of the exports of goods and services, the growth of the consolidated balance of current transactions exclusive of interest payments is evidence of this. From an average deficit of about 40 percent in 1982, this ratio dropped considerably and remained below 7.5 percent in 1984 and

TABLE 10.4

Ratio of Current Balances Exclusive of Interest Payments to the Exports of Goods and Services, 1979–1985 (percent)

	1979	1980	1981	1982	1983	1984	1985	1979–1985	1979–1983	1983–1985
Benin	−13.0	−93.2	−111.1	−96.0	−61.3	−4.8	−16.9	−56.6	−74.9	−27.7
Burkina Faso	−35.7	−24.3	−19.4	−48.6	−27.6	−36.1	−42.0	−33.4	−31.1	−35.3
Ivory Coast	−34.5	−41.2	−34.7	−18.8	−18.0	+13.7	+13.3	−17.2	−29.4	+3.0
Niger	−21.6	−31.9	−25.6	−37.4	−4.3	+10.7	+0.1	−15.7	−24.2	+2.2
Senegal	−22.3	−42.0	−47.6	−27.2	−26.0	−21.5	−17.0	−29.2	−33.2	−21.5
Togo	−60.3	−9.7	−1.8	−12.0	+2.1	+10.9	−1.6	−10.3	−16.3	+3.8
UMOA (average ratios)	−31.4	−40.4	−40.0	−40.0	−22.5	−4.5	−10.4	−27.0	−34.9	−12.6

NOTE: Investment earnings, lines 15–20 of the detailed balance of payments of the monetary fund, are calculated exclusive of direct investment earnings.

SOURCE: IMF, *Balance of Payments Yearbook Statistics*, Washington, various years.

1985. The most remarkable progress was recorded in the Ivory Coast, Niger, and Togo, where the position of the balance was even reversed. Conversely, in the countries not involved in an IMF program, signs of a lasting adjustment are not yet visible, with the result that their financial position is a source of legitimate concern.

By what means and at what social cost did the UMOA manage to improve the position of its external accounts? The process of restoring the balance involved a combination of measures, some of which tended to check aggregate demand and others to stimulate the supply of exportable goods or substitutes for imports. Theoretical arguments suggest that the adjustment of international payments is more painful when devaluation is ruled out. For a small country that is a price taker on the international commodities market, devaluation is beneficial insofar as it instantly changes the structure of relative prices in favor of goods open to international trade. In an economy with large unused production capacities in this sector, there is reason to hope that a not inconsiderable portion of the adjustment can be accomplished by the growth of supply (structural adjustment) rather than the curbing of demand (stabilization). With respect to the process of restoring the union's balance, a few remarks concerning these assertions are in order.

First, in an international environment of flexible exchange rates where the French franc fell in value with respect to the major currencies during 1981–1985, maintaining parity did not exclude a sometimes significant depreciation of the nominal effective exchange rates of the CFA franc. As shown in Table 10.5, when calculated on the basis of the structure of the imports of each country during the 1980–1986 period, the depreciation was 6 percent between 1980 and 1987 and more than 10 percent with the exclusion of Benin (where the upward trend of the index was due in large part to frequent devaluations of the currency).

Second, under the influence of internal policies, real effective exchange rates depreciated during the same period (1980 to 1987) by an average greater than 12 percent. This trend toward an improved competitive position is remarkable because it yielded additional depreciation of the nominal effective exchange rate. Usually the increased competitiveness that is instantly produced by a devaluation disappears in the ensuing months, in part because of an accelerated rise of internal prices, which compound the difficulties of implementing a rigorous policy to accompany it. In the case of the UMOA, the depreciation of nominal effective exchange rates, without changing the parity, led, on the contrary, to a deceleration of inflationary strains. Two phenomena contributed to this favorable outcome: profound changes in the conduct of monetary and budgetary policies, which led to a downward adjustment of inflationary expectations (S. Guillaumont 1988), and the exogenous depreciation in the exchange

TABLE 10.5

Variations of the Components of the Effective Exchange Rates of the West African Monetary Union, 1980–1987 (percent)

	Nominal[a]	Relative[b]	Real[c]
Benin	+16.0	−18.8	−2.8
Ivory Coast	−12.2	−5.8	−17.0
Niger	−8.9	−20.7	−24.5
Senegal	−6.3	+11.4	+5.7
Togo	−14.5	−2.0	−16.7
Burkina Faso	−9.5	−10.0	−17.6
UMOA	−5.9	−7.6	−12.2

a. Variations in the nominal effective exchange rate calculated on the basis of the 1980–1986 average import structure.
b. Variations in relative price expresssed in the various currencies of the countries in question; the + sign indicates that inflation of consumer prices in the African country is higher than the average of its partners, and the − sign means the reverse.
c. Variations in the real effective exchange rate.
SOURCES: IMF, *International Financial Statistics*, 1988 Yearbook, Washington; United Nations, *Yearbook of International Trade Statistics*, New York, various years; and World Bank, *World Tables*, 1989 edition.

rate of the French franc. Since the depreciation of the CFA franc was only indirect, it led to a phenomenon of money illusion on the part of the economic units (Plane 1988a).

Table 10.6 provides information for evaluating the comparative vitality of the reform processes south of the Sahara. On average, the real effective exchange rate of states in the union depreciated less quickly than it has since the beginning of this decade. The discrepancy has only limited significance, however; first, because the World Bank index is based on the SDR, whereas for the union the calculations are made on the basis of the currencies of the principal importing countries; but, more particularly, because many African countries outside the franc zone had to correct the excessive overvaluations that occurred in the 1970s (World Bank 1981).

The preceding observations are confirmed by the fact that between 1986 and 1987 the decline in real exchange rates in the union was due to price stability in an environment of worldwide disinflation. Conversely, the rate of price increases remained high in the other African countries, with the result that, on average, the currencies had to depreciate by about 50 percent of their nominal value at the beginning of the 1980s for their real depreciation of 20 percent to occur.

As a result of price stability within the UMOA and a policy of tight money, the central bank's real discount rate became positive, in 1988, at

TABLE 10.6
Indicators of the Results of Reforms, 1980–1987

Indicators	Periods	Sub-Saraharn African countries with energetic reform programs	Sub-Saharan African countries with lax reform programs or none	UMO
Consumer price	1980–85	18	23	7.
variations (annual %)	1986–87	16	35	0.
Nominal exchange rate (1980–82 = 100)	1986–87	48	55	97.
Real effective exchange rate (1980–82 = 100)	1986–87	79	83	91.
Central bank real	1980–82	−7.0	−7.6	2.
discount rate	1986	−1.0	−12.2	8.
Growth of GDP (con-	1980–84	1.4	1.5	0.
stant 1980 prices)	1985–87	2.8	2.7	4.
Growth of real	1980–84	−2.1	−3.7	−19.
investment	1985–87	−0.9	−7.0	3.
Gross domestic savings	1982–84	9.9	2.3	4.
(as % of GDP)	1986–87	10.7	6.0	6.

SOURCES: For general data concerning sub-Saharan Africa, see Tables 19 and 20 of the World Bank document entitled *Adjustment and Growth in Africa in the 1980s* (World Bank 1988). The averages are not weighted.
Calculations for the member countries of the UMOA are based on data from the *World Tables* of the World Bank, 1989 edition, and the IMF 1988 *Yearbook: International Financial Statistics*.

about 9 percent. At the same time, in most sub-Saharan countries, the rea discount rate remained negative, even in those countries that the World Bank considered as having energetically undertaken their reforms (Table 10.6). Despite this policy of high interest rates, the rate of domestic savings is abnormally low in the union, about 6.5 percent for 1986 and 1987 Financial crises characterized by illiquidity, even insolvency, of commercia banks cannot be considered unrelated to this fact. If bankers do not take the precaution of ensuring the security of deposits entrusted to them by the public, the temptation will be great for those who have no access to external financial markets to opt for the immediate use of savings In this context of a highly specific crisis, it is not inconceivable that in the most recent period the system of convertibility of CFA francs, which allows the unrestricted purchase of imported consumer goods, indirectly slowed the correction of national savings rates.

Judging from trends observed elsewhere, it does not appear that the refusal to adjust the parity of the CFA franc led to any specific sacrifice in the

growth of domestic products. Of course, activity was unspectacular throughout the 1980–1984 period, but the impact of stabilization policies was intensified by the consequences of climatic disasters, especially in the Ivory Coast (1982–1984) and in Senegal (1980–1984). But in the most recent period a phenomenon of adjustment has occurred that increased the average performance of the union, placing it at a level higher than that achieved anywhere else in sub-Saharan Africa.

Conclusion

Local economic measures have contributed just as much as the international environment to the severe financial crises that most sub-Saharan countries have been experiencing for the past fifteen years. Although the desire to maintain the convertibility of the currency on the basis of a fixed parity vis-à-vis the French franc can encourage the conduct of a strict economic policy, the UMOA nevertheless lost considerable ground in the monetary and budgetary spheres. Given its economic and financial opening to the exterior, the effect of these policies was to lead immediately to balance-of-payments deficits. Between 1979 and 1985 the resources that had to be mobilized solely to finance the union's international imbalances were estimated at approximately 5 billion SDRs, or more than 100 percent of the average exports of goods and services during the period.

In 1983, although national trends were fairly disparate, on the whole policies aimed at restoring the balance of external accounts resulted in real progress. Since, in the 1981–1985 period, the French franc was frequently low vis-à-vis the major currencies and moderation in the creation of internal credit resulted in remarkable price stability, maintaining the parity of CFA francs was compatible with a significant reduction in the real effective exchange rate. This approach, however, which is essential to the success of a structural adjustment, remains tenuous. And, in any case, some serious problems remain.

This is particularly true in the case of rehabilitating the banking systems, which is a factor in correcting the rate of national savings. There is also a need to continue reorganizing public finances and promoting the withdrawal of the state from economic activities, whenever the private sector can effectively take over from the public administration. An obligation also exists to improve further the competitiveness of the economies. In a difficult international environment, because of the trend of primary commodities prices and the prospects of stabilizing the exchange rate of the French franc, this improvement will greatly depend on the ability to increase productivity in the productive system. And there are questions about the parity of the CFA franc. In terms of parity of purchasing power, the currency seems unaffected by any continuing overvaluation that would

justify a departure from the current exchange rate with respect to the French franc. But the aggressive monetary adjustments carried out in certain African countries—especially Nigeria, where the external value of the naira depreciated to half its 1970 value—will undoubtedly cause problems. Finally, some of Africa's French-speaking economies view with concern the development of clandestine trade on their borders, which tends to accentuate the weakening of governments.

TABLE 10.7

Evolution of the BCEAO Operating Account and Positions of Members, 1975–1985 (millions of French francs)

Year end	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
Benin	32.9	57.6	58.3	29.6	−57.7	15.4	296.3	−78.1	−384.7	−388.1	−456.3
Burkina Faso	302.9	308	212.6	102.6	191	241.8	319.2	317.8	594.6	896	892.5
Ivory Coast	385.2	311.8	820.5	1,752.4	431.5	−2,136.4	−3,339.9	−2,981.2	−4,706.5	−3,531.4	−1,271.9
Mali[a]										250.2	84.5
Niger	191.3	372.3	432.8	485.2	470.9	500.3	514.9	98.4	329	749.5	960.2
Senegal	122.3	118.6	148.6	−62.1	−323	−637.7	−1,193.2	−1,020.4	−1,273.7	−1,027.6	−1,815
Togo	147.2	290.4	178.1	258	237.5	317	816.6	1,086.4	1,430.5	1,928.6	2,237
Unallocated	123.4	−39.9	−247.3	−78.7	142.5	646.4	869.7	1,021.9	103.7	−560.4	1,319.6
Total	1,305.2	1,418.8	1,603.6	2,487	1,092.7	−1,053.2	−1,716.4	−1,555.2	−3,907.1	−1,683.2	1,950.6
Mali	−763.1	−919.8	−837.4	−862.7	−936.1	−985.9	−1,134.8	−1,211.4	−1,271.7		

a. Mali rejoined the UMOA on June 1, 1984.

SOURCE: Banque de France.

Louis M. Goreux

Comment

I would like to make two points after the very good and complete description of the system that Patrick Plane provides. My first point is that the bulk of the quantitative analysis goes up to 1985, and I believe it would be useful to take into account what happened between 1985 and 1988. This is a small detail. The second point deals with an expansion of the monetary analysis.

On the first point, from 1985 to 1988 a number of things happened. The dollar declined very substantially in February 1985. In addition, the naira had been grossly overvalued, at least on the official market, until 1985; it has been massively depreciated, changing the competitive position of Nigeria versus other countries. Then the terms of trade of the CFA countries declined by about 30 percent from 1985 to 1988. Finally, the situation of Ivory Coast appeared remarkably good in 1985. It was almost a miracle. When we look at it today, it looks fairly grim. If all the data are examined, including those since 1985, the tone of some remarks might be slightly modified.

The second point concerns an expansion of the monetary analysis that is provided by Patrick Plane. There is no doubt, as he said in the paper, that because of the fixed parity between the CFA franc and the French franc and because of the operations account with the French treasury, inflation in CFA countries has been much smaller than inflation in most other African countries.

As a matter of fact, the system is such that the rate of inflation in a CFA country cannot differ dramatically from that in France. Many other countries, when they have had a deficit, whether it was in Africa or in Latin America, have financed the deficit by printing money, but CFA countries cannot print money. Of course, they can deviate from the famous statutory rule of 20 percent of net advance to the treasury in relation to net fiscal receipts, but they cannot print money.

This being said, I would like to stress a point that was made by Mr. Plane regarding what happened during the boom. More fully, I would like to stress that the effect of fluctuations in the terms of trade are not symmetrical; there are different effects when the terms of trade improve from when they deteriorate. One of the reasons for this is that nominal wages are more rigid when the terms of trade deteriorate than when they improve.

The Ivory Coast from 1975 to 1977 experienced spectacular increases in the prices of coffee and cocoa. In two years its terms of trade increased dramatically, by 80 percent. Simultaneously, the money supply (M2) more than doubled, exactly as Mr. Plane's paper says. Because the central bank stabilized no part of the money supply, net foreign assets were increasing as the prices of coffee and cocoa were tripling. The boom meant an increase in money supply as long as domestic credit and credit to the government were not reduced substantially. The result was that the cost-of-living index increased by 45 percent in these two years, twenty-five percentage points more than in France. Later on, when the terms of trade deteriorated, the money supply was restricted, notably during the three-year arrangement with the IMF, but it was very difficult to recover this twenty-five percentage-point increase in relation to France, which occurred in two years. In fact, it has never been fully recovered.

The example of the Ivory Coast is the most striking, but it could be repeated for many of the CFA countries. To give an overall view, I come to Table 1. The first row of the table shows the yearly increase in the cost of living in France.

For example, in 1977 the inflation rate (measured by the cost-of-living index in France) was 9.4 percent. The table has eight rows for eight CFA countries, CFA countries for which we add continuous statistical series in the higher phase. If I pick up the Ivory Coast in 1977, the number eighteen means that the rate of inflation in the Ivory Coast was 1.094 multiplied by 1.18; so the rate of inflation was about 30 percent.

If we weight the rate of inflation of these eight countries in relation to their GDP weight, we arrive in the penultimate line to the number 10.8. It means that in the year 1977 the rate of inflation in France was 9.4 percent, and for the eight CFA countries it was 10.8 percentage points more than in France. In the last row is the cumulative inflation differential from 1972. In 1972 it was zero, increasing sharply in 1977 to 21.9 percent, reaching a peak

TABLE 1

Differential between Cost-of-Living Indices in CFA Countries and France, 1970–1988

	Weights[a]	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988
		(percentage increase from previous year)																		
France		5.9	5.5	6.2	7.3	13.7	11.8	9.6	9.4	9.1	10.8	13.3	13.4	11.8	9.6	7.4	5.8	2.5	3.3	2.9
		(percentage point over increase from France)																		
Increase over France																				
Burkina Faso	0.04	−4.1	−3.4	−9.2	0.3	−5.0	7.0	−18.0	20.6	−0.8	4.1	−1.0	−5.8	0.2	−1.3	−2.6	1.1	−5.1	−6.6	1.1
Cameroon	0.21	−0.1	−1.5	1.9	3.1	3.5	1.8	0.3	5.3	3.4	−4.2	−3.7	−2.7	1.5	7.0	4.0	−4.5	0.7	6.3	5.5
Congo	0.06	−4.4	−1.4	3.6	−3.9	−8.2	5.6	−2.4	5.0	1.1	−2.7	−6.0	3.6	1.0	−1.8	5.3	0.3	0.0	−1.8	
Gabon	0.14	−2.1	−1.6	−2.8	−1.1	−1.7	16.6	10.6	4.5	1.7	−2.8	−1.0	−4.7	4.9	0.8	−1.6	1.5	−2.5	−4.2	−13.6
Ivory Coast	0.34	3.5	−7.0	−5.9	3.8	3.7	−0.4	2.5	18.0	3.9	5.8	1.4	−4.6	−4.5	−3.7	−3.1	−4.0	4.2	2.0	4.0
Niger	0.08	−5.1	−1.3	3.6	4.4	−10.4	−2.7	13.9	13.9	1.0	−3.5	−3.0	9.5	−0.2	−12.1	1.0	−6.7	−5.7	−10.0	−4.2
Senegal	0.10	−3.1	−1.6	−0.1	4.0	2.9	19.9	−8.5	1.9	−5.7	−1.1	−4.6	−7.5	5.6	2.0	4.4	7.2	3.9	−7.6	−4.6
Togo	0.04	−1.4	1.0	1.5	−3.7	−0.9	6.2	2.0	13.1	−8.7	−3.3	−1.0	6.3	−0.7	−0.2	−10.9	−7.6	1.6	−2.8	
Eight CFA countries[a]																				
Yearly	1.00	−0.3	−3.4	−1.9	2.2	0.5	5.1	1.9	10.8	1.5	0.2	−1.5	−2.6	0.0	−0.7	−0.2	−2.2	1.9	−0.6	−0.2
		(cumulated percentage price differential from 1972)																		
Cumulated		5.4	1.9	0.0	2.2	2.7	7.9	10.0	21.9	23.7	24.0	22.1	18.9	18.9	18.1	17.9	15.3	17.5	16.7	16.5

a. Country percentage differentials weighted by countries' GDP shares in 1980. The eight listed countries amount for 87 percent of the combined GDP of the thirteen CFA countries.

SOURCE: IFS.

of 24 percent in 1979, and then declining slowly to about 16.5 percent in 1988.

Therefore, we have a very sharp increase in the inflation differential during the period of improving terms of trade and a slow decline in the phase of declining terms of trade. Table 2 is based on the same principle and is very simple. It shows the terms of trade of France in the first row and then the terms of trade of the eight CFA countries in the following eight rows. In the penultimate row the table gives the weighted average of the terms of trade of the CFA countries and, in the final row, the ratio between the terms of trade averaged for the CFA countries and for France. The last rows of Tables 1 and 2 are shown in Figure 1.

What we see in the line shown as "cost of living," with the percentage shown on the lefthand side, is that the cost of living between 1972 and 1977 increased almost proportionately to the relative improvement in the terms of trade of the CFA countries. Then, of course, there was a fall in the terms of trade of the CFA countries. In spite of a sharp fall from 1977 to 1978 and even 1979, the cost of living continued to increase but moderately. As the terms of trade were more or less stabilized and a number of adjustment programs were put into place, the cost of living declined slightly in relation to the French cost of living. But definitely we do not see a sharp decline that is comparable to the sharp increase in the first phase. Of course, what complicates the matter here is that the terms of trade deteriorated very sharply after 1985. Of course, a single year is never a very good observation. But when we add up for 1988, the last year for which data were available for this meeting, we end up with the fact that in relation to the base year of 1972, the cumulative inflation rate was about 16.5 percent greater than that of France in spite of a substantial decline in the terms of trade.

That is a problem. I do not say that the sharp increase in the cost of living especially between 1974 and 1978 was due to the system of the franc zone. In fact, the central bank could have done something to stabilize the money. It was, however, relatively difficult for it to do so, because it was the first time that a national of West Africa was nominated governor of the BCEAO.

This was also in a period after the oil boom, and a number of African leaders showed that what happened for oil would happen for coffee and cocoa, that the price of raw material would go on forever, and this was a time to adjust up. Of course, what we see is that it is fairly easy to adjust up and the adjustment is fairly quick; but when one has to adjust down, the adjustment is long and painful.

TABLE 2

Terms of Trade, France and CFA Countries, 1970–2000

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979
France	97.7	99.7	100.0	102.5	87.9	94.5	93.2	91.9	95.6	95.0
CFA countries										
Benin	106.9	92.3	100.0	150.8	99.1	80.1	105.7	129.8	109.5	98.0
Burkina Faso	104.1	102.1	100.0	115.2	70.1	60.8	76.7	71.0	69.0	70.1
Cameroon	103.0	101.4	100.0	117.9	96.0	81.0	120.8	151.8	123.2	107.6
CAR	111.3	102.4	100.0	148.9	95.9	81.2	113.9	128.0	106.7	115.0
Congo	117.9	114.1	100.0	59.8	98.6	90.1	98.0	102.4	95.3	104.0
Gabon	77.7	80.8	100.0	97.2	196.9	173.5	184.8	180.3	170.4	292.7
Ivory Coast	119.1	98.9	100.0	108.2	104.9	90.2	129.6	163.8	136.4	133.1
Mali	107.0	101.9	100.0	107.9	66.4	59.6	76.2	70.9	70.9	60.4
Niger	92.5	96.6	100.0	88.2	73.6	75.8	79.3	73.6	79.5	72.0
Senegal	103.2	96.0	100.0	93.1	115.8	107.4	103.6	102.5	91.2	91.1
Togo	117.1	105.4	100.0	108.3	207.2	169.9	145.8	136.7	115.3	105.8
CFA average	112.6	100.2	100.0	104.8	105.6	93.2	117.4	138.2	117.2	114.1
CFA average over France	115.2	100.5	100.0	102.3	120.2	98.6	125.9	146.3	122.5	119.1

TABLE 2
(continued)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1995	2000
France	89.0	85.0	86.6	88.5	89.7	92.0	98.0	98.9	101.0				
CFA countries													
Benin	85.4	87.5	78.9	89.9	83.1	78.5	57.6	73.8	57.6	62.3	61.7	66.3	65.6
Burkina Faso	64.7	57.4	53.9	61.1	61.4	52.7	49.2	56.7	50.8	49.3	48.3	48.8	43.8
Cameroon	103.1	101.3	98.6	96.7	99.4	95.2	63.4	57.3	47.3	47.4	49.3	51.6	59.5
CAR	111.1	97.9	99.7	99.2	105.1	96.8	94.9	92.9	102.1	94.0	91.4	95.9	96.4
Congo	141.4	150.1	143.3	136.4	137.8	132.4	80.3	90.0	76.7	75.5	80.5	89.4	86.1
Gabon	281.7	302.0	286.2	268.5	268.7	254.6	158.6	180.0	154.4	154.4	157.2	171.3	200.8
Ivory Coast	112.5	95.1	97.4	103.0	112.1	108.1	117.7	99.3	78.7	81.9	85.3	92.7	111.7
Mali	59.3	55.0	49.0	55.1	54.8	48.4	43.6	50.3	41.5	41.0	42.5	45.6	43.7
Niger	59.0	59.0	61.1	63.2	59.0	58.4	55.5	48.9	55.9	49.6	45.4	50.4	51.1
Senegal	90.7	92.9	88.7	89.4	91.5	88.3	78.4	81.6	71.5	75.0	80.0	90.9	89.6
Togo	116.8	118.8	109.0	103.3	107.7	99.9	84.5	99.2	82.1	82.9	98.3	95.1	99.5
CFA average	112.1	107.2	104.9	105.5	109.3	104.5	83.5	80.0	70.4	67.7	69.1	71.9	77.0
CFA average over France	123.9	126.2	121.2	119.2	121.9	113.6	85.3	80.9	69.7				

SOURCE: World Bank IEC Dept., UNCTAD, up to 1987. Projections based on the 1987 export pattern and the World Bank commodity prices projections 1988–2000. For France: IFS, Jan. 1989 and Yearbook 1986, till 1985. Staff estimates for 1986, 1987 and 1988.

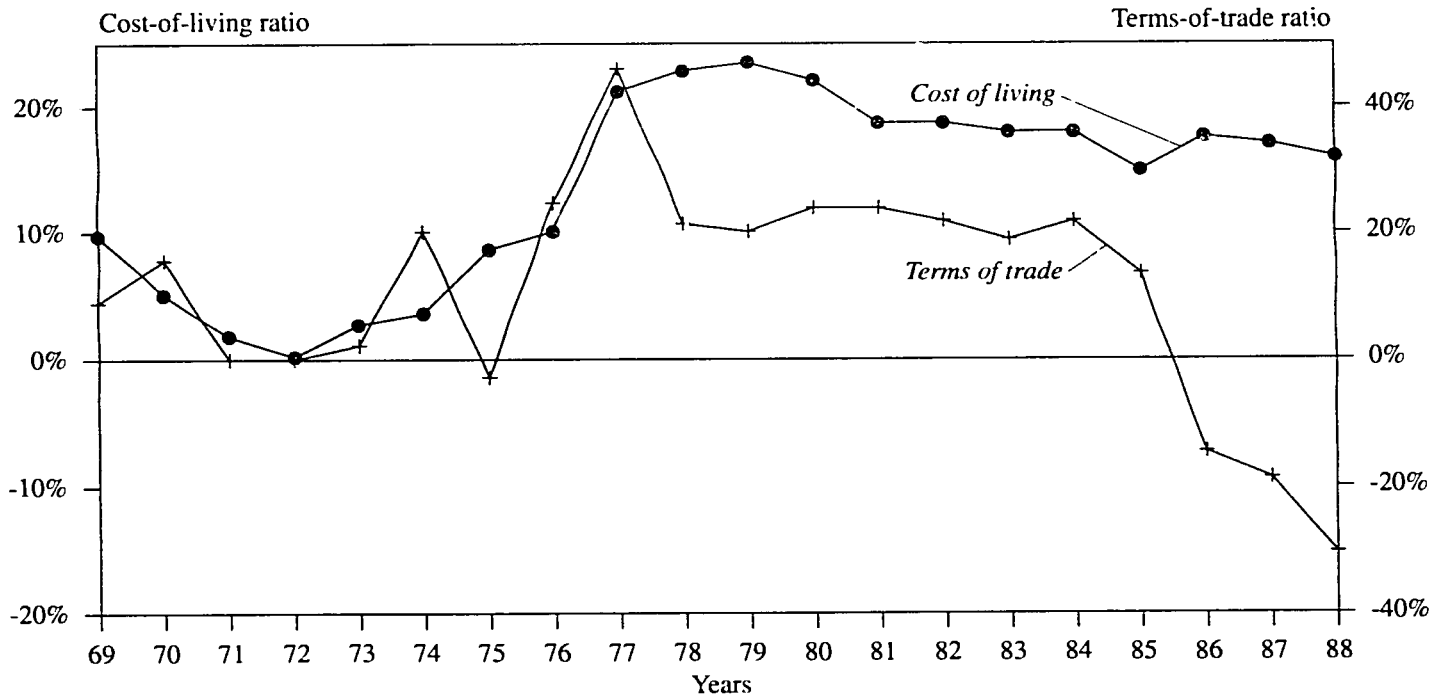

Figure 1. Ratios of Cost of Living and Terms of Trade, CFA Countries over France, 1969–1988 (percentage changes from 1972)
SOURCE: Tables 1 and 2 (last rows)

Discussion

Sergio Bortolani: It is often said—and it is repeated in Patrick Plane's paper—that the CFA franc is supported by the French franc in an unlimited way. I think this is true on paper but not in practice, because in fact before any unlimited amount can be converted into French francs, there are mechanisms in the monetary union that prevent this from happening. I would like to ask the author of this paper whether he has quantitative evidence of the magnitude of the French treasury intervention in support of the CFA franc. In my view, one big merit of the franc zone is the relatively stronger monetary discipline in the area and not so much the French treasury intervention.

Patrick Plane: I agree with you that overdraft facilities with the French treasury are neither unlimited nor a permanent means of balance-of-payments financing. As I put it in the paper, monetary and fiscal institutional arrangements prevent a situation in which economic discipline would be abandoned because the French support would cancel the external constraint.

Overdraft facilities, however, are neither hypothetical (they have been used continuously from 1979 to 1984) nor negligible; for the six countries of the West African Monetary Union (UMOA), they reached 4 billion francs in 1983 and accounted for 15 percent of the total amount raised for balance-of-payments financing during the 1975–1985 period.

Sergio Bortolani: In fact, this confirms what I said. The rules are good, and the rules prevent any possibility of having massive French treasury intervention.

Louis Goreux: I would say yes and no. Yes, if our attention is confined to the operations account, as in the Appendix of this paper. It has never been in the red in very large magnitude.

There are ways, however, to avoid having deficits reflected in the operations account by direct, external assistance to the treasuries of the various countries. When one gives balance-of-payment assistance to a BCEAO country of, say, 1 million dollars, automatically one reduces the deficit by 1 million dollars.

The deficit of the operations account has never been very large, and it has been in surplus for quite a number of years. But the countries of the CFA zone, in fact, not unlike other countries of Africa, have received sizable amounts of balance-of-payments assistance.

Mohamadou Diop: The monetary union is a typical example of the kind of union one will want to see because of the strong monetary discipline on the member countries.

I would like to hear some discussion of the current situation in Benin. When a government runs into this sort of illiquidity problem and for months is unable to pay the salaries of its employees, there is a complete loss of faith in the banking system. People no longer take their money to the banks. The banks become completely illiquid.

What I want to ask is, What are the factors that enable an institution of that type to exist in one of the member countries of the monetary union?

Louis Goreux: Benin was faced with the problem that they could not print money. They could not anymore pay their civil servants, and the government that cannot pay the civil servants or the army is a government that will fold.

Clearly Benin could have worked it out by printing its own money, but that would have created an enormous increase in inflation. In non-CFA African countries, Nigeria for example, the government would still pay the civil servants but with money so depreciated that the civil servants would receive almost nothing.

Brian Ames: It is frequently argued that the virtue of the franc zone is more with regard to the fiscal discipline that it imposes on a member country than with regard to convertibility and access to foreign exchange. I have heard it hinted in this seminar that fiscal discipline is actually lacking in these countries.

Specifically, the system explicitly limits only credit to the government and not credit to the public sector. And it seems that in recent times the deficit, or the financing of the deficit, of the public sector rather than the government proper has been more of a concern with regard to monetary implications and specifically with regard to inflation.

Second, as Mr. Goreux has said, external borrowing has provided another source of financing that lessens the discipline that might otherwise be experienced by the members.

I would therefore like to call into question the extent to which the franc zone truly imposes the fiscal discipline that is frequently attributed to it.

Patrick Plane: As mentioned in the paper, it is true that in the special international context of the 1970s, the statutory limit on bank credit to government (20 percent of the previous year's tax revenue) has been circumvented by foreign borrowing. After the second oil shock this financing proved to be more difficult to raise. On the one hand, the statutory limit became more efficient, but, on the other hand, fiscal deficits induced large payment arrears.

In 1981, trying to find a solution to the liquidity problem of treasuries, the BCEAO decided to give member governments the right to draw the counterpart funds of all transactions with the IMF, regardless of whether the 20 percent limit had been reached. Without such a decision member governments would not have been attracted by standby agreements. One cannot say that this decision stimulated inflation because IMF programs have had a domestic credit target.

The same can be said concerning the parapublic sector. The increasing part of this sector in the domestic credit outstanding has not created more inflation but has possibly crowded out the private credit demand. It is worth noting that a formal limit on bank credit extended to the whole public sector (government and public enterprises) would not have been more efficient in the 1970s. Moreover, given the wide political differences between socialist (Benin) or interventionist (Senegal) countries and market-oriented economies (Ivory Coast), it would not be easy to modify the institutional arrangements and reach a common point of view about what constitutes a "good limit."

Louis Goreux: There is no doubt that a system like the franc zone system can work well only if there is budgetary discipline. As it happens, the governing body of the BCEAO is the board of the Ministry of Finance, and the supreme body is the meeting of the heads of state. Fiscal discipline cannot be imposed on the minister of finance and the heads of state if they do not want to apply it. What can be done is what is now occurring.

If fiscal discipline is not practiced and the system gets in trouble, that may be sufficient to draw the attention of the heads of state to the difficulties that must be overcome to maintain the benefits of the union. Now there is an attempt to avoid the mistakes and the excesses of the past, because budgetary discipline was modified in many different ways, as you mentioned.

The very classic way was precisely not to give more credit to government once it had reached the famous 20 percent rule. But then credit was given to public enterprises rather than to government to provide subsidies

to the public enterprises. Of course, this credit was guaranteed by the government and was refinanced by the central bank. It was not counted in the 20 per ent. In my opinion it should have been counted in the 20 percent, because it is very easy to get around it.

Regarding external credit, which has been a problem in the late 1970s and early 1980s, it is not really very much of a problem now because there are not so many banks wanting to lend for balance-of-payment purposes to the countries anymore. In fact, not a single bank wants to lend a penny. So the problem is not there. Maybe it would be the World Bank that is lending too much or the IMF that is lending too much. But usually we are told that the IMF is too strict rather than too lenient. So I would say that the system would have worked well had there been strong budgetary discipline.

In fact, this discipline has not occurred. In 1975–1977, for example, the central bank did not effectively reduce the money supply essentially because the heads of state at the time did not want that to be done. They wanted a big expansion, and the governor of the central bank would probably have been removed from office if he had failed to do what they told him to do.

Nevertheless, a central bank covering seven countries now, and with France having something to say, is more likely to be independent than if it were the central bank of a single country, because then the governor can be removed in a minute, on the dot. In this case it is much more complicated. But it is not foolproof.

Brian Ames: It appears that the conclusion to be drawn from this is that it is not the regime itself that is imposing the fiscal discipline. Mr. Goreux is arguing that ultimately it is the fiscal discipline imposed by the member country's authorities that would be binding here. Or in this case, as you are arguing, it would be the fiscal discipline that is imposed externally by a World Bank structural adjustment program or an IMF standby arrangement.

Therefore, it cannot be said that the virtue of the system is the imposition of fiscal discipline. It ultimately gets down to a question of the political commitment of the authorities to impose monetary and fiscal discipline. And this is true whether we are talking about a franc zone country or a non–franc zone country.

Kerfalla Yansane: I would like to come back to the French guaranty. Even if this guaranty does not apply, it still has a psychological role. First, it gives confidence to these countries and, second, it reinforces the solidarity among countries. I feel that was very important in the beginning.

Of course, all these countries after independence were likely to have their own money, and France's guaranty was essential to these countries' acceptance of working together. Having said that, I should also note that these countries are experiencing problems not only because of rigidity or because of accelerating borrowing but also because of the lack of economic integration among them. They have been working together for thirty

years now. They have the same money, the same central bank, but no economic integration. That is a big problem.

Another issue that I would like to hear discussed regards monetary policy and exchange rates. I know that the credit control is very strict, but in the face of adjustment programs these countries might experience greater difficulties than others because of their inability to alter the exchange rate of the CFA franc vis-à-vis the French franc.

Patrick Plane: To a certain extent, the process of economic integration exists in the UMOA. The trade flows are not negligible between Ivory Coast and Burkina Faso or Senegal and Mali. Moreover, there are large international labor movements between member countries. This economic integration is certainly less developed, however, than was hoped when the monetary union was created in 1962.

Several reasons can explain this relative failure: the narrow political interests that, from time to time, prevail on the economic welfare principles, the lack of structural complementarity between the economies, the main products being exported to developed countries.

On the issue of monetary policy and exchange rates, as Table 10.6 of the paper shows, in the past seven years the real effective exchange rate of the CFA franc depreciated in approximately the same proportion as the other sub-Saharan currencies in spite of its fixed parity vis-à-vis the French franc. Thus the exchange rate regime has not been detrimental to the increase of the price ratio between traded and nontraded goods, which is a prerequisite for the structural adjustment process to occur. The depreciation of the real exchange rate was the result of a restrictive monetary policy but also of a favorable international environment with the devaluation of the French franc and the appreciation of the U.S. dollar. At present the external environment is not so good. Thus if the UMOA members want this parity to be unchanged (consensus being needed among all members for any modification to occur), they have to be cautious with monetary policy and try to improve the productivity of the economies.

Patrick Honohan: I want to come back to the point Mr. Yansane raised about this being a union, not just a fixed exchange rate regime. A lot of what we have been talking about applies to any kind of fixed exchange rate regime that one country might have.

One of the things we might expect from a union is that there would be, if not a lot of trade between the countries, at least some kind of monetary pooling of resources. Another is the advantage mentioned by Mr. Goreux, that the central bank, being an international institution, would have a greater independence from the national treasury.

In fact, it does not seem to have worked out that way at all. Yes, in a sense there has been pooling, but the pooling has been very much to the advantage of two or three member countries at the expense of the other three in the West African zone. It is not so clear in the central zone, but

certainly in the West African zone, where events have been more dramatic anyway.

The Ivory Coast, Senegal, and to a lesser extent Benin, three countries that are the richest countries in per capita income, have grabbed the lion's share of the monetary financing that has been available. A conspicuous example, actually, is embedded in the Appendix to Mr. Plane's paper; if we glance down the column for the use of the operations account of the French treasury for 1984, we see that although the zone as a whole was only indebted to the extent of about 1.5 billion in 1984, Ivory Coast was indebted to the extent of 3.5 billion, well over twice the total of the zone. It seems to me that the distribution of power in the zone is something that has not been adequately discussed and there is quite a conspicuous inequality.

The other point is the independence of the central bank. A more independent central bank would surely not have allowed individual countries to drag the zone into the degree of indebtedness that it has already achieved. It would also not have lent to banks that were evidently insolvent and whose financial restructuring is now going to eat further into the resources of the zone.

So there are serious concerns about the functioning of the zone as a union, not simply its functioning as something that chooses the right exchange rate and the right agricultural produce prices.

Louis Goreux: This is an interesting question, of course. When we see that the BCEAO countries with a surplus in the operations account are Niger, Burkina Faso, and Togo—for some special reason linked with Nigeria—and that the countries in deficit are the Ivory Coast and Senegal, we almost reach the conclusion that the poor countries are lending to the rich countries.

If we look at the other zone, we see that the countries in surplus are Chad and Sierra Leone and that the borrowing countries in deficit are Cameroon and even Gabon. While this looks a little strange, why does it happen?

I may be wrong, of course, but here is what I think. The logic would be that when a country is poor, that country receives quite a bit of external assistance covering the purchase of domestic goods and services. This means that when the World Bank makes a project in Burkina Faso or Chad, the country is so poor that it even has to be given the foreign exchange for providing for so-called local costs. A country that is relatively poor like Burkina Faso sends workers to the Ivory Coast, a richer country, and the workers send back money. There is, therefore, a substantial flow of foreign exchange, inflow of foreign exchange, to purchase local goods and services. Part of it results in additional purchase of foreign goods and services, but part remains in the country. As long as this process occurs, there is a continuing inflow of new foreign exchange. There are new

workers' remittances. There is new external assistance. Therefore, there is an aberration.

Viewed this way, one can readily conclude that in fact it is normal that the poorer countries have a surplus. This surplus could be used by the government, but according to the rule of the system it cannot be used directly by government in excess of the 20 percent statutory limit, though it could be lent to the private sector, to enterprises. But the well-known problem is that it is very difficult to find a bankable project in very poor countries; commercial banks commonly consider the rate of return too low or the potential borrower not credit-worthy. Therefore, the banks are left with some money, which, of course, they want to invest. So they lend it in the money market of the union; and since there is always an unsatisfied demand in, say, the Ivory Coast and Senegal, it ends up in the Ivory Coast and Senegal. So we reach the somewhat ironic result that is apparent in Patrick Plane's Appendix. But this is the way, in fact, the capitalistic system works—just as someone in Africa would invest in Japan or America, because the rate of return on the dollar is better in Japan, although the Japanese are not in need of money.

The funny thing is, of course, that there are organizations that share the funds of the bank, which are supposed to provide support for balance-of-payments deficits, lending instead to countries with balance-of-payments surpluses. The reflow goes to a country like Ivory Coast, with a balance-of-payments deficit.

I just made a note on this apparent paradox: effectively, the system of the zone is such that usually the countries with surpluses are the poorest, and the countries with deficits (since 1978) have been those that are the richest.

Patrick Honohan: At first sight this argument that the marginal efficiency of capital is higher in Ivory Coast seems convincing. Thus all the money flows there because it is a great economy, great potential. But, in fact, the money has flown to do what? To finance bad loans to banks, gone down the drain.

[Laughter.]

Donald Mathieson: At the IMF board this is called a two-handed intervention.

Mohamadou Diop: I have heard many things with which I do not agree. First of all, I think that to make an assessment of the performance of the union, one should look at its performance over time and what has happened since its creation, not just the period of time covered by this paper's Appendix.

From 1960 to the early 1970s, two countries were supporting the union. It was Senegal until about 1968. From 1968 on it was almost exclusively the Ivory Coast and then, during a brief period, Niger. All other countries were in a deficit situation.

What was operative was the principle of solidarity. It is like a credit union. Some people have very high credit accounts; others have very high debit accounts. But over time each member's debits and credits might come to zero. This is the way we have to look at it. What worries me about these comments is that in spite of the precision given by Mr. Goreux about, for example, the Nationale Monetaire, it introduces an issue that is eliciting responses that are dangerous for monetary policies and adjustment policies. These responses are akin to those of the authorities in Burkina Faso. Burkina Faso is structurally a surplus country from a national monetary standpoint, as are Togo and Mali. But what characterizes these countries is the lack of investment opportunities and the lack of use of the banks.

This phenomenon was observed in the mid-1970s, when the Nationale Monetaire had an overall surplus. Today, in Mali, Burkina Faso, and Togo, there is a great deal of discipline. But what is happening in Burkina Faso today is that the authorities have decided to siphon off the excess liquidity in the banking system to finance housing. There is no way that the central bank can prevent this. But what is going to be the consequence? I leave it up to economists to judge.

Regarding what Mr. Ames was saying about the indirect financing of the budget through public sector enterprises—again, there is a tendency to lump everything together. There is cash crop financing, for example, through certain extension service enterprises in Senegal. There are a multitude of service industries that provide implements and services to the peasants. Then there is the public sector, the public utilities for water and electricity, and some productive and profitable product enterprises. There is no reason why the bankers should not finance an industrial, productive, and profitable enterprise even though that enterprise is controlled 100 percent by the state.

There are what we call *les établissements publics*. The legal regime is different from enterprise to enterprise. But what I am saying is that it is unwise to lump them together. When we look at the deficit, we have to look at the deficit from subbranch to subbranch to come to a conclusion as to whether it has any effect on the budget.

What I have seen is lumping and generalization. That is a mistake; it is too complex an issue. I think you are right with respect to some public sector enterprises, but I urge the importance and merit of determining *which*.

So in terms of whatever research is going to be done, it is necessary to avoid generalization, to segment, and to look at these public enterprises and not to forget also that the central bank existed before independence. I worked in the central bank in the late 1960s and the early 1970s. The central bank does provide fiscal discipline in its rule. When the rules of the game are applied and adhered to it does, but one must make a distinction

between the rule and its application. Again, the central bank has made mistakes. It has recognized them. The governments have made mistakes.

There is an adjustment process by which, for example, most of Senegal's public sector enterprises had their accounts at the public treasury. With the adjustment agreement with the IMF and the World Bank, many of these public sector enterprises are becoming quasi-private enterprises with the government as sole shareholder (*associé national*). What is important is that they have autonomous financial management and no longer have to open an account with the treasury. They are in the market, which is a good thing for the banking system. This, of course, is being done on a case-by-case basis, because not all of them are in a position to become *associés nationaux*. But the result we are seeing is that the treasury is having a cash problem as these enterprises are being weaned from its purview.

Another factor is the pension funds, the special security funds, and the insurance companies. In Senegal, at least, the insurance companies, by law, must put in a public treasury account a major portion of their provisions for risk. As long as I can remember, the public treasury has not applied the rule because of the magnitude of the insurance companies' term deposits in the commercial banks. The minister of finance could technically, in theory, wipe out those deposits just by telling the insurance companies that their legal requirement to put, let's say, 80 percent of their provisions for risk in a public treasury account must be fulfilled tomorrow.

There is also the pension fund, which by Senegalese law, because these are public sector pension funds, must also leave its money in special treasury accounts. The pension fund at one point reached almost 25 billion CFA in the 1970s. It has dwindled now. If the public treasury ever decides that these funds must be deposited at the central bank, there will be considerable problems.

I would conclude by saying that a recent study I have done for my bank has shown that in the union, some 60 billion CFA of deposits from the guaranty funds and from some of the public regional development banks are deposited with the central bank. My mission was to try to see to what extent we can get the authorities to free those funds and to allow those institutions to deposit them in commercial banks. These regional funds should be explicitly included in any assessment of the potential for financial development in Africa.

Ulrike Wilson: The first point I want to stress is the strong difference that exists between the BEAC, which has not been mentioned here, and the BCEAO. The degree of integration is considerably less in the BEAC than in the BCEAO. While the latter is a monetary union, the BEAC is a *zone de coopération monétaire*. It does not pretend to be a union and is not a union. It does not go through the exercise of unionwide macroeconomic

forecasting to set credit ceilings, as the BCEAO does, but is a much less centralized organization.

The BEAC also allows the banks and the individual member countries to set differential interest rates; these start from the common discount rate of the central bank, but they can apply differential margins to it. So there are considerable differences in interest rates applied in the individual member countries. That was my first point.

The second point I wanted to ask about is how the plafond—the 20 percent ceiling on bank credit to government—is actually applied in the BCEAO. In the BEAC we have found that when government revenues dropped sharply because of declining oil revenues, the central bank took a long time to adjust the plafond downward officially. The ceiling should normally reflect the revenue of the previous year, but in many cases it is argued that the final data are not yet available; so the wait is often longer. Recently the BEAC waited for about three years before it made the adjustment. Since then it has actually talked about the old plafond and the new plafond. The three countries affected by this are in effect staying at the old plafond, and their only penalty for that is to pay one percentage point more interest than they would pay normally on central bank advances to the government. I would like to know, for instance, in the case of Ivory Coast, where I presume government revenue has declined in recent years, how that was dealt with and whether there is a stiffer penalty for staying at the old plafond.

Louis Goreux: In the case of Mali, I do not believe that any penalty was imposed.

Clark Leith: There are two quite different questions that do not seem to have been addressed in this discussion. One is, What is the cost to the member countries of holding their reserves in francs, rather than holding them in some more diversified portfolio? This is something that could be of considerable interest.

The second relates to some of the more micro detail that could be important for individual members. Again, should we be looking at just the franc as the comparison, or should we be looking at, for example, the real exchange rate relative to the naira, relative to the SDR and other potentially interesting currencies for these individual countries?

Patrick Plane: I will briefly answer the first question. For the member countries, the cost of holding at least 65 percent of their foreign currency reserves in the French franc is limited. This is for at least two reasons: First, the French treasury pays an interest rate on those reserves to the BCEAO. This rate is equal to the rediscount rate of the central bank of France. Symmetrically, the African central bank has to pay interest on the use of overdraft facilities, but never more than the bank of France rediscount rate.

Second, after the French franc devaluation of 1969, African countries

asked for more protection of their external reserves against the risk of exchange rate variations of the French currency. Under the current cooperation agreement between France and member states (1973), France provides an exchange rate guarantee for these deposits vis-à-vis the SDR.

Louis Goreux: Regarding the comparison of the CFA with the French franc as against some other currency, the SDR or whatnot, in fact, there is a classical calculation of the effective exchange rate, nominal and real. These indices are sometimes very confusing because they are supposed to be one single index, which gives the answer for everything, but they have been used and abused.

Yet we need to know what countries are being taken into account in calculating what the effective exchange rate is. For example, in most of the calculations of the IMF, Niger, Nigeria, and Ghana are included, according to my knowledge, but that is never written anywhere. If countries like Ghana or Nigeria are included, what kind of exchange rate do we use? Their oficial exchange rate or their nominal exchange rate? There is not a single index that can give the answer. Very often one has a tendency to talk in terms of the relative exchange rate, by deflating by the cost-of-living index. But there is no reason why it should not be as interesting to deflate by exporting values, the terms of trade, or whatnot, and in fact the IMF is now publishing relative exchange rates for industrialized countries, but for some odd reason this is not done for the African countries.

I believe that it could be as interesting to compare the terms of trade with the relative exchange rate as with the cost of living. This is just to say that when one wants to make this comparison, there is not an easy answer. In fact, if there were an easy answer, we would not need economists. We would not be meeting here.

319

11

Anthony Saunders

Nonbank Financial Innovations in East Africa

In recent years there have been major moves by a number of African countries toward liberalizing their financial systems. In doing so there has been the belated recognition that real sector economic development and a free (or relatively free) financial sector are inextricably linked. While the conditionality requirements of International Monetary Fund (IMF) and World Bank structural adjustment programs have provided some of the motivation for these developments, they would not have occurred without the endogenous acquiescence of the government (in some cases) and the endogenous motivation of the private sector (in others).

In the first section of this paper, I look at theories explaining why financial innovations occur. I define innovations broadly to include new instruments, institutions, and processes. The two major theories of innovation are market completeness theory and constraint-induced theory. These theories imply certain major causes of financial innovation. In the second section I review the causal framework implied by these theories and look at the evidence from applying this framework to U.S. data. In the paper's third section I examine the causal framework in the context of recent financial innovations in three East African countries: Kenya, Mauritius, and Tanzania. I show that important additional causes of financial innovation (compared with the United States) are foreign exchange shortages and conditionality

laid down by World Bank and IMF structural adjustment programs. Moreover, many of the financial innovations in East Africa are government sponsored (either directly or indirectly), whereas in the United States and other first world countries innovations are largely endogenous to the private sector. In the chapter's fourth section, before its summary and conclusion, I examine why some innovations succeed and others fail and link this to the interdependent nature of the financial innovations process.

Theories of Financial Innovation

Market completeness. Market completeness theory has its theoretical foundations in the work of Arrow (1971) and Debreu (1959). In a complete market there are a sufficient number of financial instruments available (for example, stocks, bonds, futures, options) to hedge every conceivable "state of the world" that might arise. For example, a commodity price collapse, an oil shock, and rapid economic growth are different potential states of the world with different probabilities of occurrence. Thus an incomplete or imperfect financial market is one where there are insufficient instruments available to enable individuals to hedge every state-contingent risk if they so wish. Hence financial innovations (new products, instruments) can be viewed as a process of completing the market, a process of developing (in the limit) a sufficient number of financial instruments to span the whole state space (feasible set of state outcomes). In general, it has been shown (see Arditti and John 1980, for example) that the number of financial instruments (m) necessary to span all state possibilities (n) is not one to one. That is, by combining (diversifying across financial instruments) such instruments as options and futures it is possible to create synthetic securities that hedge certain potential risks (states). Hence in general m is less than n.

Van Horne (1985) has provided a more practical interpretation of market completeness theory. He views financial innovations as a mechanism by which economic agents (individuals, firms, or governments) can improve their return-risk trade-offs. Market completeness occurs when no (new) innovation can improve such a trade-off. Further, the incentive to innovate will increase the greater the range of possible outcomes or states facing the investor. Thus, for example, a major spur toward completing the market through innovation is greater uncertainty of price (interest rate, goods, price, exchange rate) since this expands the feasible set of possible outcomes in the state space.

Constraint-induced theory. This theory developed by Silber (1975, 1983) views agents as maximizing their utility or wealth subject to a set of regulatory and economic constraints. In a sense it can be viewed as a reformation of the Arrow-Debreu framework to provide some new insights into financial innovations. Economically, one can think of agents maximiz-

ing their utility in the context of a linear-programming-type model. According to Silber, the more binding the set of constraints, the greater the incentives for agents to introduce new financial instruments and processes to avoid these constraints. Hence this is a theory of constraint-induced innovation. Importantly, not only do restrictive regulations, such as foreign exchange controls, interest rate ceilings, and taxes spur innovations (to avoid such regulation), but so do economic constraints. Thus increased volatility of interest rates or other prices is viewed as imposing increased constraints on an agent's actions, inducing him to introduce new instruments or processes to alleviate such constraints.

Elsewhere Kane (1981) has given a slightly different interpretation of the constraint-induced theory of regulation. Kane conjures up the notion of a "regulatory dialectic," by which governments impose restrictions on financial activities that induce agents to innovate ways around these constraints. This in turn leads governments to impose restrictions on any new set of activities. Consequently regulatory avoidance is viewed as the major spur for innovation—which is speeded up by improvements in technology. That is, Kane views technology as a mechanism by which agents can respond (through new innovations) to government regulation and reregulation.

While it is difficult, if not impossible, to test the market completeness innovation theory directly and difficult to test the constraint-induced theory (see Ben-Horim and Silber 1977 for an effort to do so), these theories are useful in that they suggest a framework of causes that can be employed to explain different financial innovations. While this framework is to some extent ad hoc, it does offer a significant improvement on simply descriptively listing financial innovations as separate or independent events.

A Causal Framework for Financial Innovations

The underlying theories of financial innovation suggest a number of major causes of financial innovation. In particular, from the work of Van Horne (1985), Silber (1983), and Finnerty (1988), who seek to explain financial innovation in the United States, a set of major causes can be identified.

The approximate causes of financial innovations. *Inflation and the level of interest rates.* The higher the rate of inflation, the greater the incentives of agents to introduce new financial products that lock in a real rate of interest or at the very least a nominal interest rate that is responsive to inflation. Also the more costly it is for lending agents to adhere to interest rate ceilings.

The volatility of prices and interest rates. The greater the volatility of prices and interest rates, the greater the risk faced (by risk-averse agents),

and the greater are the incentives to develop new instruments or products (such as futures, options, swaps) to hedge such risk.

Tax laws. The higher the tax rates either on income (dividends and interest) or on capital gains, the greater are the incentives to develop innovations (such as zero-coupon/deep discount bonds) to lower the tax burden.

Regulation. Regulation encompasses both ceilings (such as those on savings deposit and loan interest rates) and activity constraints (such as permitted areas of lending or investing). The more costly it is for an agent to adhere to such restrictions, either in lost income or profits, the greater the incentive to innovate new activities (such as nonbank financial institution—NBFI—finance companies) lying outside the boundaries of current regulation.

Technological advances. The greater the speed with which information can be collected and transactions processed, the lower the (average) cost of introducing new innovations, and the lower the cost of regulatory avoidance.

Level of economic activity. The greater the level of economic activity (and therefore the greater the level of savings), the greater is the demand for innovations as investment vehicles. Also the greater the opportunities to mobilize new savings.

Other causes of innovation. These include internationalization, reduced agency costs, increased liquidity, academic work, and accounting benefits.

A classification of financial innovations. If the preceding are the approximate causes of financial innovations, how can the different innovations be classified? The broadest classification scheme distinguishes between innovations that are new products or instruments and those that are new processes or institutions. New products could be further divided into those that are consumer-oriented products (such as new types of savings accounts) and those that are corporate- or government-oriented products (such as corporate bonds).

In this paper, a three-part classification scheme is used: (1) consumer innovations, (2) corporate or government innovations, and (3) financial process innovations.

Applying the causal framework to unclassified innovations. In the Appendix to this chapter, Tables 11.2, 11.3, and 11.4 present applications of this causal framework to recent financial innovations in the United States. Specifically, Table 11.2 shows the analysis of major causes of innovation by Silber (1983) for the period of 1970–1982, Table 11.3 shows the analysis of Van Horne (1985) for the period 1978–1984, and Table 11.4 shows the analysis of Finnerty (1988) for the period 1968–1988. These tables are fairly easy to interpret. Thus Silber (1983) argues that three major causes for the

innovation of zero-coupon deep discount bonds were the level of interest rates, tax effects, and the volatility of interest rates. In contrast, Van Horne (1985) attributes the same innovation to the level and volatility of interest rates and (perhaps surprisingly) academic work, and Finnerty (1988) attributes zero-coupon bonds to the level and volatility of interest rates, tax effects, and risk reallocation effects. Thus, although there is agreement that the level and volatility of interest rates were a major cause of this innovation, there is some disagreement over the other causes. This, of course, is partly due to the rather ad hoc link of this framework to the underlying theoretical models and the difficulty of developing more direct tests of the innovations process.

Notwithstanding the essentially ad hoc nature of this framework, I examine, in the next section, how well it fits recent experience in three East African countries: Kenya, Mauritius, and Tanzania.

Application of the Causal Framework to East Africa

In the preceding section six major causes of financial innovations in the United States were identified: (1) inflation and the level of interest rates, (2) the volatility of prices and interest rates, (3) tax laws, (4) regulation, (5) technological advances, and (6) the level of economic activity. These stimuli are sufficiently universal to be expected to explain a large number of East African financial innovations.

Two important causal constraints, however, that are very relevant for African countries (but not so relevant for the United States) need to be added: foreign exchange constraints and IMF and World Bank structural adjustment programs. The greater the shortage of foreign exchange receipts (because of commodity price falls or export collapse) and the stringency of exchange controls, the greater the incentives for agents to develop methods either to avoid such controls or to introduce new methods to collect foreign exchange. And the greater the conditionality imposed by structural adjustment programs (linking additional hard currency loans to financial liberalization), the greater the incentive for agents to avoid even more binding foreign currency constraints by adhering to a liberalization program.

Thus is an international and foreign currency dimension added, in African countries, to the causes of financial innovation in the United States. Furthermore, the question of who does the innovating appears to be somewhat different between the U.S. and African experience. Virtually all the innovations in Tables 11.2 to 11.4 (for the United States) can be attributed to private sector initiatives in response to the causal factors. By contrast, many of the financial innovations recently witnessed in East African countries are government (or parastatal) sector initiatives. This suggests that, since the U.S. and East African financial markets are at very

different stages of development, government sponsorship of innovations may be necessary at early stages of financial development but that eventually the private sector has sufficient profit incentives and motivation to be the primary (if not the sole) source of financial innovation. Of course, one problem with innovations not driven by the private sector, by governments seeking social rather than profit objectives, is that such innovations may have a greater propensity to fail a market test than will commercially driven innovations—although privately sponsored innovations can and do fail as well.

The three East African countries analyzed are at different stages of financial liberalization: Tanzania (just beginning to liberalize), Kenya (in the middle of liberalizing), and Mauritius (undertaking major reforms of its financial sector). While these countries have different political ideologies as well as per capita incomes, it is of interest to examine what common threads the "causal framework" offers in explaining major financial innovations in these countries over recent years. It should be stressed that the list of innovations, while fairly comprehensive, is probably incomplete and the attribution of causes to innovations is based on my judgment and in a number of cases is probably contentious.

The table presented in the text of this chapter, Table 11.1, summarizes the major innovations in three countries: Kenya (K), Mauritius (M), and Tanzania (T), by compiling them into the three components of our previously determined classification scheme: (1) consumer product innovations, (2) commercial product innovations, and (3) financial processes innovations. These are combined with eight potential causes of innovation that have been previously identified: (1) inflation and the level of interest rates, (2) the volatility of prices and interest rates, (3) tax laws, (4) regulation, (5) technology, (6) the level of economic activity, and the constraints of (7) foreign exchange and (8) IMF and World Bank structural adjustment programs. Moreover, innovations are further subdivided by whether they are "largely" driven or sponsored by the government sector (G) or by the private sector (P). Finally, while informal foreign currency black markets and lending markets are genuine "innovations," this chapter is confined to more formal innovations only (although black markets can easily be explained within this causal framework).

First, looking at consumer sector financial innovations, (1) and (2) are savings bonds introduced by the government of Mauritius in 1987 and 1988. Both bonds were introduced as a means of absorbing private sector savings and increasing competition for savings with the banking sector. In the first issue of these bonds (eight-year maturity), the zero-coupon (deep discount) form proved nearly ten times more attractive than the eight-year coupon-bearing bonds. As Table 11.1 indicates, the major difference between these instruments is that the zero-coupon bonds allow the investor to avoid tax while, with the coupon-bearing bonds, the buyer has to pay

TABLE 11.1
Financial Innovations in East Africa

Innovation	Country[a]	Causes[b]	Sector sponsor[c]
A. Consumer products			
1. Savings bonds	M	1, 2, 6	G
2. Zero-coupon savings bonds	M	1, 2, 3, 6	G
3. Credit cards	M, T, K	5, 6, 7	P
4. Mutual funds	M	2, 5, 6	G
5. Interest-bearing checking accounts	K	1, 2, 4	P
B. Commercial products			
1. Corporate bonds	M	1, 4	P
2. Leasing	M, K	3, 4	P
3. Venture capital	K	2, 4	P
4. Guaranteed small business loans	K	1, 2, 4	G
C. Processes			
1. Stock market reform	M	4, 6	G
2. Foreign-currency-funded development banks	M, K, T	4, 7	G
3. Offshore banking	M	4, 6, 7	G
4. Merchant banking	K	1, 2, 4	P
5. Finance companies	K, M, T	1, 4	P
6. Treasury bond auctions	K	1, 2, 8	G
7. Treasury bill secondary market	K	8	G

a. Country: K = Kenya; M = Mauritius; T = Tanzania.
b. Causes: 1 = inflation and the level of interest rates; 2 = the volatility of prices and interest rates; 3 = tax laws; 4 = regulation; 5 = technology; 6 = level of economic activity; 7 = foreign exchange constraints; 8 = IMF/World Bank structural adjustment programs.
c. Sponsor: P = private sector; G = government sector.

income tax on coupons. Here not only are high income tax rates a major cause of this innovation, but also (legal) tax avoidance is a major reason for this innovation's relative success.

The next innovation is the increasing use of credit cards and travel and entertainment cards (particularly American Express). This is made possible by the use of satellite technology that allows a U.S. cardholder, for example, to use his card for expenditures in Kenya and virtually anywhere else. Moreover, such cards are an effective source of foreign currency for foreign-exchange-constrained countries such as Kenya and Tanzania. Finally, to the extent that economic activity and per capita income are rising, they increase payments convenience by relieving the constraint of having to hold and pay for goods and services in cash. As might be expected, credit

cards are (relatively) more widely used and distributed in Mauritius, where the per capita level of economic activity is higher than in Kenya or Tanzania.

The fourth consumer innovation is mutual funds. As part of its stock market reform package, the government of Mauritius through the State Commercial Bank and State Investment Corporation is sponsoring the sale of open-ended mutual fund shares. The advantages of a mutual fund are that it allows investors to diversify stock price risk better (cause #2), while exploiting technology that allows the value of the mutual fund portfolio to be marked to market frequently (cause #5). In addition, mutual funds become an extremely attractive vehicle for investors when there is a rising level of economic activity and an expanding volume of savings (cause #6).

The fifth consumer innovation is interest-bearing checking accounts, recently introduced by Citicorp in Kenya. Rising levels and volatility of inflation and interest rates clearly increase the opportunity cost for holding non-interest-bearing checking accounts (causes #1 and #2), which is accentuated if there are also regulations regarding ceilings for maximum interest payments on the nearest available substitutes, such as savings deposits (cause #4). In particular, in periods of inflation individuals (savers) prefer explicit payment of interest to payments in kind, such as low service charges.

The second group of innovations are commercial product innovations. In 1988 the Mauritius Leasing Corporation was established. Since this corporation was not a bank, it could not, because of regulation, raise finance through deposits (cause #4). Instead it made a five-year maturity, 11½ percent coupon, corporate bond issue that paid coupons competitive with bank savings rates and treasury-bill rates—although not as competitive as the rates on the zero-coupon savings bonds discussed earlier (cause #1).

Both Mauritius and Kenya have leasing companies—the second commercial innovation. In Mauritius the leasing company is an independent financial institution, while in Kenya the companies are subsidiaries of the major banks (Standard and Chartered). The major reasons that leasing companies were established and are thriving in both Mauritius and Kenya are tax advantages either to the lessor (in Kenya) or to the lessee (in Mauritius)—cause #3. Leasing is also a mechanism of regulatory avoidance (cause #4) in that it allows agents to avoid restrictions on banks' holding (directly) real long-term equity in their asset portfolios.

Venture capital involves the participation of an outside investor or group of investors in the equity of small, risky projects or firms. Thus long-term equity participation differentiates a venture capital firm from a bank that makes short-term loans to small business (although if a loan goes bad a bank will end up, ex post, with an implicit equity participation in the company). As with leasing, venture capital firms are a form of regulatory avoidance of, or escape from, limits on banks' directly holding real equity

in their portfolios. Further, it is only by careful selection, close monitoring, and diversification that a venture capital firm can survive the high risk of its investments—which in turn are the reasons for its existence (cause #2).

The absence of bank finance to small companies is widely seen as a constraint on financial and real development in many African countries. Banks, particularly in Kenya, Tanzania, and Mauritius, seem to concentrate on making relatively short-term loans to large-scale private and parastatal customers. This leaves only the high-interest informal credit market sector as a source of loan finance to small-scale enterprises. The role of guaranteed loans, as in Kenya, is to reduce the cost of funds (relieve the constraints implied by causes #1 and #2) to small business by offering banks a risk-sharing or coinsurance default risk guarantee. In addition, such guarantees allow banks to avoid coming up against regulated maximum loan rate ceilings (cause #4).

The third set of financial innovations are broadly defined as new or reformed financial processes. Although Mauritius has had a stock market for over 100 years, by the end of 1987 it was totally moribund and was ill serving the rapidly growing real sector of the economy. Thus to accommodate better a growing level of economic activity and demand by firms for long-term funds (cause #6), which, because of regulation and inertia, were not being accommodated by the banking system (cause #4), the government has sponsored a major reform of the stock market. This includes building a new exchange, the establishment of a Securities and Exchange Commission (SEC), a complete body of new laws (modeled on those of the United States), as well as reformed trading practices. It was felt that without undertaking such reforms the financial sector would prove a drag on the continued development of the real sector.

Because of foreign exchange regulations (cause #4) and foreign exchange shortages (cause #7), corporations in many African countries have had great difficulty importing key raw materials and other vital inputs. Development banks that are funded by foreign currency loans (provided by overseas sponsors such as the World Bank, the European Economic Community, and others) are often viewed as a financial innovation that partially alleviates these foreign currency constraints. Thus the International Development Bank and the Development Finance Company of Kenya and the Tanganyika Development Finance Company Limited are development banks built on this model. While these development banks may be an innovation that has alleviated certain foreign currency shortages, however, they have also raised new problems and constraints, such as enormous interest and principal foreign currency burdens for indigenous firms, in the face of major devaluations of local currencies. This suggests that the success of one financial innovation may crucially depend on (be interdependent with) the presence of other innovations, in this specific case, instruments that allow indigenous firms to hedge foreign currency

risk (see the next section of this chapter regarding sources and failure of financial innovations).

A third recent financial process innovation has been offshore banking. Mauritius has recently passed legislation to allow the establishment of offshore banks. An offshore bank is basically a shell organization that attracts foreign currency deposits from nonindigenous agents (capital flight) and lends these deposits on to other nonindigenous agents, or, in the case of Mauritius, provides foreign currency short-term working capital loans to firms in the country's export processing zone. Offshore banks are innovations to alleviate foreign currency shortages (cause #7) and to avoid regulations such as limitations on indigenous agents' ability to borrow or hold foreign currencies abroad (cause #4). Moreover, they may enable the financial sector better to accommodate real sector needs for expansion (cause #6).

Merchant banks are a specialist group of financial institutions that provide longer-term finance (longer than commercial banks) to the real sector of the economy. This longer-term finance may include venture-capital-like equity participations or longer-term loans. In the case of Diamond Trust of Kenya, however, recently voted the most innovative financial institution in Kenya, the services provided also include underwriting equity issues—such as the new issue or initial public offering of its sister company Jubilee Insurance. Thus merchant banks are an innovation that can be attributed to regulations limiting the ability of commercial banks to provide long-term financing (cause #4) as well as to the level and volatility of interest rates (causes #1 and #2) that may make new equity issues more attractive sources of finance than longer-term debt or loans. Only two new equity issues, however, have been made (underwritten) by merchant banks in Kenya in recent years, mainly because of an unavoidable regulatory constraint that allows a government-sponsored Capital Issues Committee to decide when (and at what price) a new private equity issue can be offered to the public.

Finance companies (often labeled NBFIs) are an additional innovative financial process. Finance companies exist in Kenya, Mauritius, and Tanzania. While, like banks, they often issue savings deposits (but not checking accounts), they tend to concentrate their lending either on asset-backed commercial finance (such as the financing of inventories of goods) or asset-backed consumer finance (for example, hire purchase). One of the major reasons for their establishment has been regulatory avoidance of interest rate ceilings on bank savings or lending rates (cause #4). Thus in Kenya during periods of rising interest rates (cause #1) during the 1980s, the ceilings on bank savings and lending rates became increasingly binding. By establishing NBFI subsidiaries, banks could get around such ceilings. Moreover, even when (as in the Kane regulatory dialectic, referred to above) regulators sought to impose ceilings on NBFI lending rates, these ceilings were still 4–5 percent higher than bank lending rates, so that

institutional arbitrage remained attractive. Thus regulatory avoidance has been a major cause for the establishment and growth of NBFIs.

The final two process innovations are financial market innovations. It is in this area that IMF and World Bank structural adjustment programs (cause #8) appear to have had the most effect in driving financial innovations. Thus, as part of its structural adjustment programs, Kenya has increased the menu of longer-term financial assets by introducing longer-term treasury bonds sold through a discriminatory auction. In such an auction, subject to minimum price (maximum yield) constraints, the investor (agent) is free to enter a competitive bid for a desired quantity of bonds. While there are some technical problems with the current auction procedures, the major advantages of these competitive auctions is that they allow investors to manage interest rate risk better (causes #1 and #2). An additional aspect of the Kenyan structural adjustment programs has been the start of a nascent secondary market in treasury bills as a precursor of an eventual reorientation of monetary policy, away from credit ceilings and controls, toward a policy based on open market operations (a monetary policy, that is, more consistent with a liberalized financial sector).

This section has shown that East African financial innovations, broadly defined, fit quite well into the causal framework suggested by the complete market and constraint-induced theories of innovation. Specifically, a relatively limited set of causes appear to offer a reasonable explanation of a wide array of innovations. While it is impossible to reach anything other than qualitative conclusions, it does appear that regulatory avoidance (cause #4) and the level and volatility of prices and interest rates (causes #1 and #2) are prime determinants of the scale and scope of financial innovation in these countries.

In the next section we look at the reasons for the success and failure of financial innovations. Obviously, the mere appearance of a financial innovation is insufficient for its success; it may fail through lack of demand or inefficient (cost-effective) supply.

The Success and Failure of Financial Innovations

Table 11.1 listed sixteen financial innovations. In most cases these innovations (such as offshore banking and stock market reform in Mauritius) are so new that it is hard to say whether they will be successes or failures. In other cases, however, it is possible to explain why an innovation has failed or succeeded.

Failures. Mauritius coupon-bearing savings bonds attracted relatively little investor interest. The reason for the failure of this innovation is that it was clearly dominated by the zero-coupon savings bonds issued at the same time. In particular, the zero-coupon bond offered the same nominal gross yield with greater protection against interest rate risk and after-tax

returns. In the terminology of the complete market paradigm, the coupon-bearing savings bonds were redundant securities in that the zero-coupon savings bonds dominated in terms of return-risk trade-off. Thus an innovation will tend to fail whenever its return-risk characteristics are already closely replicated by an existing financial instrument or some combination of existing financial instruments. Conversely, a successful financial innovation should offer investors a new risk-return trade-off.

Foreign-currency-funded development banks are, a priori, important innovations in reducing capital market incompleteness (by supplying longer-term finance in hard currencies to foreign-currency-constrained indigenous importers), but it is also arguable that they have exacerbated market incompleteness by expanding the range of foreign currency risks faced by indigenous borrowers. In the case of Kenyan and Tanzanian development banks, large proportions of their loan portfolios are in arrears or in default, while in others funds remain unborrowed. If well-developed, forward foreign exchange markets (currency futures or options) were available to indigenous firms in these countries, then firms might be able to cover some of their foreign exchange rate risk by taking a position in the forward market—buying foreign exchange forward three months to meet an expected foreign-currency-denominated interest payment in three months' time (Saunders 1989). Unfortunately, the actual and expected one-way downward path in the spot exchange rates of many African countries vis-à-vis the dollar (and other hard currencies) has meant that no agent (central bank or commercial bank) has desired to pay the price to act as the counterparty in forward market transactions (notwithstanding foreign exchange control restrictions on such markets). For such markets to exist there must be some finite probability that the spot rate might appreciate instead of just depreciating in the near future, and the future supply of foreign exchange must be reasonably guaranteed (it must be deliverable).

As a result, the relative success or failure of one financial innovation (in this case, foreign-currency-backed development banks) is intimately linked (interdependent) with the successful innovation of other financial instruments—such as forwards, futures, or option contracts that enable the risks of foreign exchange to be hedged. Thus for some financial innovations there is an unavoidable degree of jointness inherent in evaluating their potential success.

Success. One private venture capital firm in Kenya has been highly successful. Although virtually all projects to date are associated with the Asian community, this does not attenuate the firm's demonstration that venture capital is clearly not a "redundant security" in the Kenyan context. Its success is evidence, instead, of the very limited alternative suppliers of equity. In particular, although there is a stock market in Kenya, which lists some fifty-five stocks, it has been virtually moribund, with only two new

issues since 1980 and a trading volume of no more than a few thousand shares per year. Thus any innovation that provides a new source of long-term equity in local currency is likely to be successful as long as the venture capital firm closely monitors and keeps track of the chosen projects and picks the projects on the basis of commercial criteria alone (adopting other criteria is a failing of many local currency development banks). Therefore, net present value criteria should be used only with discount rates sufficiently high to reflect the appropriate private degree of project risk.

In sum, as the three cases above imply, the success or failure of financial innovations appears to depend on two key features: the relative uniqueness of the innovation (its lack of redundancy in terms of risk-return trade-off) and the degree of independence of the innovation's risk-return performance from the presence or absence of other innovations.

Summary and Conclusions

In this chapter recent financial innovations in East Africa have been identified. To understand these innovations better an analytical framework has been used that had links to the underlying theories of financial innovation. Using this framework, it was shown that a relatively small number of causes could explain innovations and that many innovations resulted from initiatives to escape economic or regulatory constraints—such as inflation, foreign exchange shortages, and interest rate ceilings. This framework was additionally useful in identifying reasons for the relative success or failure of financial innovations.

Appendix

TABLE 11.2

	Exogenous causes							
	1							
Types of innovations	a	b	c	2	3	4	5	6
A. Cash managment								
1. Money market mutual funds	x							
2. Cash management/sweep accounts	x				x			
3. Money market certificates	x					x		
4. Debit card	x				x			
5. NOW accounts	x							
6. ATS accounts	x				x			

(continued)

TABLE 11.2
(continued)

	Exogenous causes							
	1							
Types of innovations	a	b	c	2	3	4	5	6
7. Point-of-sale terminals					x			
8. Automated clearinghouses					x			
9. CHIPS (same-day settlement)					x			
10. Automated teller machines					x			
B. Investment contracts								
i Primary market								
1. Floating rate notes				x				
2. Deep discount (zero-coupon) bonds	x		x	x				
3. Stripped bonds	x		x	x				
4. Bonds with put options or warrants	x			x				
5. Floating prime rate loans				x				
6. Variable rate mortgages				x				
7. Commodity-linked (silver) bonds				x				
8. Eurocurrency bonds	x						x	
9. Interest rate futures				x				
10. Foreign currency futures							x	
11. Cash settlement (stock index) futures						x		
12. Options on futures				x		x		
13. Pass-through securities						x		
ii Consumer type								
1. Universal life insurance				x				
2. Variable life policies		x						
3. IRA/Keogh accounts			x			x		
4. Municipal bonds funds			x			x		
5. All-saver certificates	x					x		
6. Equity access account		x		x				
C Market structures								
1. Exchange-traded options								x
2. Direct public sale of securities								
Green Mountain Power Co.				x				
Shelf registration				x		x		
3. Electronic trading								
NASDAQ					x			
GARBAN				x				
4. Discount brokerage						x		
5. Interstate depository institutions					x	x		
D. Institutional organization								
1. Investment bankers/commodity dealers	x			x				
Salomon/Phibro, Goldman Sachs/J. Aron, DLJ/ACLI								
2. Brokers/general finance								x
Shearson/Amex, Bache/Prudential, Schwab/Bank of America								

(continued)

TABLE 11.2
(*continued*)

	Exogenous causes							
	1							
Types of innovations	a	b	c	2	3	4	5	6
3. Thrifts with commercial banks	x			x		x		
4. Financial centers (Sears Roebuck)								x

NOTE: Column headings: 1 = Inflation: a = level of interest rates, b = general price level, c = tax effects; 2 = volatility of rates; 3 = technology; 4 = legislative initiative; 5 = internationalization; 6 = other.
SOURCE: Silber 1983.

TABLE 11.3

	Primary causes[a]
Products	
Money market investment accounts	1, 2
Super NOW accounts	1, 2
Interest rate and stock index futures markets	1, 2, 6
Options on futures contracts	1, 2, 6
Municipal bond mutual funds	1, 3
Zero-coupon bonds and coupon stripping	1, 6
Adjustable rate preferred stock	1, 3
New variations of adjustable rate mortgages	1, 2, 6
Securitization of pass-through and other mortgages	1, 2, 5
IRA accounts	3
Universal life insurance policies	1
Currency option loans	1
Interest rate swaps and currency swaps	1
Forward interest rate loan contracts, with ceilings and floors	1
Bonds with put options	1, 3
Issuance of and investment in high-yield (junk) bonds	1, 6
Processes	
Automatic teller machines	2, 4
Point-of-sale terminals	4
Financial transactions by personal computer	4
Shelf registrations	2
Electronic security trading	2, 4
Electronic funds transfer	4
New variations in credit card processing	4

a. Cause notation: 1 = volatile inflation and interest rates; 2 = regulatory; 3 = tax law change; 4 = technological advance; 5 = level of economic activity; and 6 = academic work.
SOURCE: Van Horne 1985.

TABLE 11.4

Innovation	Factors primarily responsible[a]	Innovation	Factors primarily repsonsible[a]
	Consumer-type financial instruments		
Broker cash management accounts	7	Money market mutual funds	6,7
Municipal bond funds	2,4,6	Money market accounts	6,7
All-saver certificates	6,7	NOW accounts	6,7
Equity access account	1,6,8	Bull/bear CDs	2
Debit card	2,7,11	IRA/Keogh accounts	1,6
Tuition futures	4,8	Universal or variable life insurance	1,7,8
Variable or adjustable rate mortgages	7	Convertible mortgages or reduction option loans	2,7
	Securities		
Deep discount/zero-coupon bonds	1,4,7	Stripped debt securities	1,4,7
Floating rate notes	4,5,7	Floating rate, rating sensitive notes	3,4,5,7
Floating rate tax-exempt notes	4,5,7	Auction rate notes/debentures	2,3,4,7
Real yield securities	2,4,5,8	Dollar BILS	4,7
Puttable-extendible notes	2,3,4	Increasing rate notes	3
Interest rate reset notes	3	Annuity notes	11
Extendible notes	2,4	Variable coupon/rate renewable notes	2,4,6
Puttable/adjustable tender bonds	2,4,7	Variable duration notes	4,7
Euronotes/Euro-commercial paper	2,4	Universal commercial paper	4
Medium-term notes	2	Negotiable CDs	2,5
Mortgage-backed bonds	4	Mortgage pass-throughs	2,4,5
Collateralized mortgage obligations	2,4,5	Stripped mortgage-backed securities	4
Receivable-backed securities	4,5	Real-estate-backed bonds	4,5
Letter of credit/surety bond credit support	4,11	Yield curve/maximum rate notes	4,6,7
Interest rate swaps	4,6,7	Currency swaps	4,6

Interest rate caps/floors/collars	4,7
Foreign-currency-denominated bonds	4,7
Dual currency bonds	4,6
Commodity-linked bonds	4,6,8
Gold loans	4,8
Exchange-traded options	4,9
Interest rate futures	4,7,9
Options on futures contracts	4,7,9
Warrants to purchase bonds	4,7
Convertible adjustable preferred stock	1,4,5,7
Remarketed preferred stock	1,4,5,7,11
Single point adjustable rate stock	1,2,4,5,7
Variable cumulative preferred stock	1,2,3,4,5,7
Adjustable rate convertible debt	1,10
Puttable convertible bonds	3,4,7
Synthetic convertible debt	1,10
Convertible reset debentures	3
Master limited partnership	1
Americus trust	4,6
Puttable common stock	3,4,10
Remarketed reset notes	2,3,4
Eurocurrency bonds	7
Indexed currency option notes/ principal exchange rate linked securities	4,6,7
High-yield (junk) bonds	2,5,7,9
Foreign currency futures	4,9,11
Stock index futures	4,8,9
Forward rate agreements	4,7
Adjustable rate preferred stock	1,4,5,6,7
Auction rate preferred stock	1,4,5,7
Indexed floating rate preferred stock	1,4,5,7
Stated rate auction preferred stock	1,3,4,5,7
Convertible exchangeable preferred	1,2,10
Zero-coupon convertible debt	1,11
Mandatory convertible/equity contract notes	1,6
Exchangeable auction preferred	1,2,4,5,7
Participating bonds	3,4
Additional class(es) of common stock	11
Paired common stock	4

(*continued*)

TABLE 11.4
(continued)

Innovation	Factors primarily responsible[a]	Innovation	Factors primarily repsonsible[a]
	Financial processes		
Shelf registration	2,6,7	Direct public sale of securities	2,6
Discount brokerage	2,6	Automated teller machines	2,11
Point-of-sale terminals	11	Electronic security trading	2,11
Electronic funds transfer/		CHIPS (same day settlement)	7,11
automated clearinghouses	7,11	Cash management/sweep accounts	7,11
	Financial strategies/solutions		
More efficient bond call strategies	7,9	Debt-for-debt exchanges	1,7,10
Stock-for-debt swaps	1,7,10	In-substance defeasance	1,7,10
Preferred dividend rolls	1	Hedged dividend capture	1
Leveraged buyout structuring	1,9,11	Corporate restructuring	1,9,11
Project finance/lease/asset-based financial structuring	4		

a. Notation: 1 = tax advantages; 2 = reduced transaction costs; 3 = reduced agency costs; 4 = risk reallocation; 5 = increased liquidity; 6 = regulatory or legislative factors; 7 = level and volatility of interest rates; 8 = level and volatility of prices; 9 = academic work; 10 = accounting benefits; and 11 = technological developments and other factors.
SOURCE: Finnerty 1988.

David Glasner

Comment

In the short time I have had to study this paper, I have not been able to come up with a great deal to disagree with. But it did seem to me that one could go further in simplifying the analytical framework of the paper than Professor Saunders has done. So let me suggest how that might be done, and along the way I will mention one or two minor quibbles that I had with some specific points. Then in closing I will try to suggest some normative conclusions that we might be able to draw from the approach that Professor Saunders has laid out for us.

The simplification that I propose concerns the two theories that Professor Saunders lays out for us: what he calls the market completeness theory and the constraint-induced theory, which, it seems to me, are essentially two ways of describing the same theory. Or stated a little bit differently, the constraint-induced theory of financial innovation is really subsumed under the broad market completeness theory of the Arrow-Debreu framework.

In the Arrow-Debreu framework markets are incomplete when not all potential states of the world can be hedged by the purchase or sale of an appropriate financial instrument. So if there are any conceivable instruments that could eliminate or allow some reallocation of risk but they are not available, then the market is in some sense incomplete.

What would account for such a gap in the array of available financial instruments? In the most general possible formulation, it must be because the potential benefits from increased hedging or risk reallocation oppor-

tunities do not cover the transactions costs associated with creating new instruments and making new markets for those instruments.

So it seems that within the market completeness theory there is already a theory—at least implicitly—of costs or constraints that are inhibiting or preventing further expansion of the menu of financial instruments. What that means is that any constraint-induced innovation—that is, some innovation arising out of a desire to avoid some kind of regulation, for example—has to correspond to something within the Arrow-Debreu framework that increases the return to creating and marketing a previously unavailable instrument or something that alters the cost of creating and marketing that instrument.

For example, if there are ceilings on deposit interest rates and inflation goes up, a money market mutual fund, which might not have been a viable instrument with the competitively determined deposit rate, can become a viable instrument. The costs of creating that instrument are now worth bearing, because there are benefits available to having that instrument that were not available before the regulation became binding.

Just to show how Saunders's discussion can be handled easily within the Arrow-Debreu framework, let me discuss briefly some of the specific causes of innovation that Professor Saunders mentions and indicate briefly how each of them can be handled strictly within the Arrow-Debreu framework.

First of all, Professor Saunders lists inflation. Inflation as such is a little bit problematic because I am not sure that inflation by itself would be a cause of innovation. Pure inflation, if it is occurring at a steady rate, does not increase anybody's risk, and therefore it would not make markets in any sense less complete than they had been before. It is only when inflation is combined with either regulation or increased volatility, so that there is uncertainty about inflation, that financial innovation will be induced by inflation. So I would make that slight correction in the list that is given.

Moving on, we come next to volatility. Volatility—say of the price level or of interest rates—increases the demand for risk reallocation. It increases the demand for risk reallocation because of different tolerances for bearing inflation risk. It makes it worthwhile to incur the costs of adding new markets that will allow people who want to avoid or hedge against inflation risk or perhaps create to do so while also creating an opportunity for people with differing expectations of inflation and perhaps information advantages to bet on their different expectations or superior knowledge. But whatever is going on, inflation volatility obviously creates an environment in which there is increased opportunity for trading, which will make it worthwhile to incur the costs of adding a new market for a new instrument.

Tax laws, which are the next cause that Saunders mentions, alter the relative benefits from hedging with alternative instruments by imposing

different tax burdens on different instruments. So the effect of taxes is to alter the spectrum of returns, thereby making some instruments or markets for some instruments more viable than they had been in relation to other instruments or other markets, under a given inflationary and regulatory environment.

Regulation, which is the next cause mentioned by Saunders, makes some instruments prohibitively costly and makes it impossible for trading to occur in those instruments. Whatever benefits they might potentially have provided will have to be provided by alternative instruments. So regulation creates an opportunity for financial innovation to provide instruments to take the place of those instruments the regulations have suppressed.

Technological advance reduces the cost of adding new markets. So technological advance will generally stimulate innovation because it reduces the costs of adding new markets for new instruments.

The level of economic activity is another source of innovation mentioned by Saunders. I understand that cause to operate by increasing the number of traders. Greater economic activity means that there are more traders and more transactions taking place, more people making market transactions. Reduced, in consequence, is the level of transactions costs associated with creating a new market, thereby enabling new markets to arise because of the larger number of potential participants in the market. So in some sense the fixed costs of creating a new market can be spread over a larger number of traders.

In addition to these basic causes of financial innovations, Professor Saunders goes on to list a couple of additional causes. One of them is foreign exchange constraints, which troubled me a little bit, because I do not see how foreign exchange constraints arise except in the presence of some regulation. It would seem to me that that ought to have been subsumed under the general heading of regulation.

Professor Saunders then takes this framework and applies it to some specific cases. And for someone, such as myself, with no knowledge coming into the discussion of the specific institutional characteristics of the innovations he discusses, there is not much to say.

Let me, however, comment briefly on his discussion of the failure of innovation. It seems to me that, again, the simple Arrow-Debreu framework provides all that is required to understand why some innovations succeed and others do not. In abstract terms there are potential benefits from adding new markets for new instruments. They provide benefits that induce a certain amount of trading.

But the problem is whether there are enough potential traders to make it worthwhile to incur the costs of adding a new market. What is needed is either a great enough benefit—some innovation that will create a great enough benefit for people to be willing to incur those costs—or some way

of reducing the cost sufficiently to make it worthwhile for the new market to be introduced.

I am really describing two blades of the Marshallian scissors. In other words, you need the right relationship between demand and supply or between benefit and cost for an innovation to be possible. Anything that reduces the cost or that increases the benefit sufficiently will make a potential innovation a successful one.

Similarly, anything that prevents the cost of an innovation from falling can make the innovation unsuccessful. For example, in Professor Saunders's case, the lack of a foreign exchange market that allows people to hedge makes it too costly to trade in a second potential innovative market for the related market to be successful.

On that point, however, I do have another issue on which to take some exception with Professor Saunders. He seems to suggest that the mere fact that everyone is certain that the exchange rate will move in one direction is enough to forestall the development of a futures market in foreign exchange. That does not seem correct, because forward suppliers of foreign exchange will always be willing to supply future foreign exchange if the discount is deep enough to make it worthwhile. As long as there is some uncertainty about the rate of depreciation, so that there are differing expectations about what the future exchange rate is going to be, there is at least the potential for a futures market or a forward market in foreign exchanges to function, even if everyone agrees that the exchange rate is going to fall.

The reason that I would suggest for the failure of the forward market to function is that there are not enough demanders of forward exchange in these currency markets to make it worthwhile for somebody to offer that forward cover. In other words, since the market is not deep enough, the discount that potential suppliers of forward cover will settle for is higher than demanders of forward cover are willing to pay. So the market cannot get started.

All this discussion suggests a normative question that we might take up briefly, which is whether financial innovation is desirable. Within the broad Arrow-Debreu framework I should say that whenever financial innovation enables a mutually advantageous reallocation of risks to be achieved, an allocation that was not previously achieved because it was too costly, the innovation is desirable in the sense that it is welfare improving.

The environment is a little bit more complicated, however, because, as we have seen, innovation can be a response to regulation. In a regulatory context we can decide whether innovation is desirable only by deciding whether the whole package of regulation and induced innovation is desirable. Or put another way, when we do a cost-benefit analysis of the regulation, what we have to take into consideration is whether the benefits from regulation are sufficient to outweigh all its costs, including the

additional resource costs that will be associated with any starting markets for new financial instruments to get around the regulation.

In particular, one might ask whether there are any gains accruing to countries as a result of internal monetary policies that increase price level, interest rate, and exchange rate uncertainty and that therefore induce financial innovation to hedge against those risks. Are there any benefits from those policies that offset the resource cost of the induced financial innovation to try to hedge against or reallocate the risks that are created, aside from any other costs associated with those policies? If, as I suspect, the answer is that there are no such gains, it might suggest that an appropriate policy for international development assistance would be to make the continuation of assistance to developing countries contingent on the abolition of the institutions that create that uncertainty, namely central banks, and allow a different set of institutions (such as private banks constrained by legally binding contractual obligations) to arise that would not create the price level, interest rate, and exchange rate uncertainty that is the result of central bank policies.

Discussion

Joshua Greene: I must say that while I found your paper interesting, Professor Saunders, I was disappointed that it did not cover certain aspects of financial institutions that the term nonbank normally implies. I wonder if you have any comments to make about developments in or the role of, for example, savings and loan institutions, insurance companies, or other types of noncommercial bank financial institutions in African countries, as we are addressing the issue of the financial sector in African countries and how to strengthen it.

Anthony Saunders: As I said, it was not a complete list of financial innovations. I was trying to concentrate on more recent innovations. For example, in Kenya, Jubilee Insurance Company has been there for a considerable number of years. One thinks of it more as an established financial institution than as an innovation. And it is heavily regulated. My understanding is that insurance companies in many of these countries are as heavily regulated as the commercial banks.

In some sense one can think of financial innovation as ensuing from the regulation of commercial banking and of financial innovations as evasions of this regulation. These regulations apply also to other parts of the established financial sector, in which I would include life insurance companies in particular.

I was grouping life insurance companies with commercial banks as the established financial sector and looking at innovations as ways to get around regulations and other economic restrictions on the activities of

these institutions. That is where the life insurance companies were placed in my framework.

In Tanzania there is one savings bank that has just been established, and it was in enormous trouble. But it seemed to me that most of its activities are in checking accounts and replicated those of the commercial banking industry. Again, this paper was more concerned with more novel forms of innovation than with traditional financial sector firms.

Michael Sarris: To put the thesis of the paper in common language, it says that when an economy is overregulated, overtaxed, and distorted, people will innovate to find ways around overregulation, distortion, and overtaxation. That, I think, is true, and we see it all over in Africa, in informal markets, in parallel markets, and in the financial and the production sector. But I think the issue that concerns us is somewhat different, and it goes as follows.

Many African countries have been left behind in terms of the sophistication of financial markets and instruments that are available. One can take the view on one hand that things that should be happening will happen at the right pace. Do not try to force them. On the other hand, in many cases we are advising governments, for example, to get rid of credit ceilings as a means of regulating monetary growth. But once we say that, the question arises, How else am I going to check how fast the money supply is growing, particularly if I do not have the instruments that will permit me open market operations?

Another manifestation of this: at the World Bank we have said that there was an absence of long-term credit, and we have set up institutions that specialize in that with, I would say, fairly uniformly disastrous results. Some people would say that is because the instruments were not there in the first place. Put institutions in place in a market that does not have those instruments, and they will fail.

The question really is, How can we tell when a country is ready for X and Y financial innovations? How can we put in place the conditions that will allow some of these countries to catch up and catch up in a sensible way? We cannot say we are going to put a very complicated stock market in, say, Malawi. That is simply not in the cards. It is not going to happen.

What we are looking for is some kind of framework that will allow forward movement in developing financial markets, without trying to push on a string.

Anthony Saunders: My paper presents a static framework, if you like, and you are asking the question, Is there a dynamic model that underlies financial development? I tend to agree with you. If we think about this, once we do change something in the financial sector, such as interest rate ceilings, we change the whole course of market policy. We move away from a credit control regime to a monetary policy regime based on monetary

growth or money-based control. How long should the intervals be between these changes, and what is the logical method of change?

In the United States, if we go back even to the nineteenth century, most of the financial innovations were induced by the private sector. In some sense the government would impose regulations, the private sector would develop innovations to escape those regulations, and the government would reregulate. It is like a regulatory dialectic. But most of the innovations have come from private sector motivations, from the private sector system endogenously. The government has only come in as a regulator rather than a sponsor of many innovations.

So there is that model, if we think of the United States as being the most financially developed country in the world and as having been underdeveloped. How did it move from its underdeveloped state to the developed state? It seems mostly through this regulatory dialectic of private sector initiative followed by government regulation, followed by private sector initiative to avoid these constraints.

But as to the causal framework developed in the paper, it is really a static model, looking at one picture—a picture at one point in time, but not really developing a dynamic model for financial innovation.

Jerry Wolgin: I would like to follow up on what Michael Sarris was asking. What we have here is a very elegant sort of framework that says the market is going to develop mechanisms to fill in spaces as they appear; yet a lot of the discussion of preceding papers suggested that there is a missing set of private interventions, particularly in terms of long-term capital.

The one question that I have is, Why is it missing? There seems to be a market there. Regulation clearly is one problem—there may be ways of getting around it—and yet there does not seem to be any development of mechanisms to supply what looks to be a space in the system.

Anthony Saunders: I can think of other reasons that are not listed here why long-term capital markets do not emerge in many of these countries, including the way in which wealth is constrained and distributed. In addition, as David Glasner said in commenting on my paper, a number of parties need to be trading to create markets for new financial instruments. If there is no breadth or depth in a market, any given financial instrument is more likely to fail than if it were introduced into a more active market. In economies where the level of nonhuman wealth is quite low and, additionally, the levels of nonhuman wealth are highly concentrated, one should not expect much trading.

For example, consider privatization. How does one privatize a company in East Africa? One cannot bring in the stock market, because it is nonexistent or moribund. One needs to find a number of wealthy individuals. There are not that many wealthy individuals there in the market to make this a viable exercise. So it seems to me that the level and distribution

of wealth are important criteria for assessing the prospects for success of a long-term capital market. For example, it has been as the level of wealth has risen that Mauritius has decided to reform its stock market. It has decided that now it is time to move away from a stock market that meets for ten minutes a week, to one where there is constant activity. We open every day, and we try to start active trading in shares.

What was the basis for that? I suggest that there was sufficient growth in the number of individuals in the economy having a level of wealth that enables trading in that market. That was the number one criterion. They perceived that they had reached that stage. But how do we know the appropriate time? Perhaps we could look at the deposit base of the country. How many individuals have deposits over a given size? We know that that is a potential wealth source that could be transferred into longer-term equity.

There is a stage where economies build up, wealth builds up. The distribution of wealth changes, and a core group of people emerges that makes trading possible and provides the foundations of an equity market. We need to have a core group of people with different expectations to get trading to occur.

Jerry Jenkins: Milton Friedman's recommendation to the British, predating the advent of Margaret Thatcher by ten years, was that their state-owned enterprises should be "given" in equal shares to its citizens (who had obviously already *paid* for them with past taxes and other costs). *This* innovation would resolve Professor Saunders's dilemma regarding "how to privatize" and simultaneously respond to inequalities in the distribution of wealth, which he has just deemed as being a fundamental source of the "missing markets" raised by Jerry Wolgin's question.

Should Professor Saunders or anyone else be interested in Friedman's proposed innovation, please know that a working model for its implementation was provided during the 1970s by the provincial government of British Columbia.

Sergio Bortolani: It is quite clear from Table 11.1 that there is a relationship between the degree of financial innovation and the degree of financial sophistication in the systems. Tanzania is mentioned only three times, and out of three cases, two are probable failures.

Before speaking of financial innovation for most of the African countries, we should focus our attention on traditional good banking services, which are still lacking. I would consider one of the biggest innovations for most African countries the reduction of corruption in the financial system and the reduction of mismanagement.

Anthony Saunders: I was asked to concentrate on nonbank innovations. That is why banks are ignored. But I agree. For example, in Tanzania I gather it takes six months to clear a check—there is only bank, and it takes six months to clear a check from one part of the country to another. There

is a clear case of a need for financial innovation, to speed the check-clearing system.

I agree with you. It sounds as if these are more fundamental issues. You are saying, "Let's make the banking system work before we worry about more fanciful innovations in the financial system," and I could not agree more.

Alan Gelb: There is a sense from the paper that developing countries tend to absorb innovations that have become commonplace in more complete markets. But there are some very interesting examples where developing countries have introduced new contractual forms that are probably way beyond anything in industrial economies.

To give one example, there are very interesting housing contracts in Ecuador, designed to deal with extreme macroinstability, fluctuations in real wages and real interest rates, and accepting the fact that one may have to forgive loans at a certain point.

It is interesting why these things come up where they do. Why in Ecuador, for example, and are there lessons there for other countries? It is also interesting that, in what should be very sophisticated economies, one sees examples of contracts that ought to be around but that somehow never really seem to get going, like commodity price–linked international debt. Why don't we see that kind of contract more? It would seem an example of very good risk sharing.

One of the cases cited here is a venture capital company. That is particularly interesting because a lot of the questions relate to exactly the kind of financing gaps that a venture capital company is supposed to bridge. This is a company that you indicated was a successful example. One of the preconditions that is usually thought of as necessary for a venture capital company is a well-functioning stock market, in order to be able to divest holdings. It is certainly true in advanced venture capital companies. So why is this case successful? If it is successful, why does it not seem to depend on the existence of an active stock market?

Anthony Saunders: As you say, normally when we think of venture capital, we think of the role of the stock market as the mechanism to cash in. If I think of the process of financial innovation exemplified by the venture capitalist, it entails his monitoring various projects, picking projects he thinks will work, applying an appropriate rate of discount to his expected cash flows, and closely following the projects and their entrepreneurs. One question is left: How does he cash in? He has put money in, he has put time in. How does he cash in? In developed economies the cashing in comes through the stock market, through bringing the issue to market and cashing in. For IPS Kenya most of these projects were very small firms, which were sold to other private individuals. In other words, an informal market developed for selling the projects when they reached fruition.

Of course, such sales are not sufficient for meeting the demands of a larger, growing venture capital movement, but they may very well be necessary to that very growth and to active stock markets. With such markets, of course, cashing out takes the form of issuing an initial public offering on the stock market. This would have occurred more frequently in Kenya but for restrictive regulations imposed on the new issues process by a Capital Issues Committee. In my opinion the stock market in Kenya is not working because of the regulatory activities constraining the ability of the stock market to work. The natural venture capital cashing-in process could work in the Kenya context, if new issues were allowed to come to the market in a natural fashion, in a less regulated fashion.

Donald Mathieson: Just a couple of comments on this. On the innovation side, especially the physical factors like tax law regulation and all that, it might be quite possible to simplify the story further and to turn it into a fiscal story, in the sense that a lot of the tax laws and regulations are designed as a package essentially to raise resources from the financial system, and they are mutually reinforcing.

A lot of the "innovations" that we see in the system are means, no less than is capital flight, of trying to escape that taxation. If this hypothesis is true, then I am not so sure how good innovation is in a highly distorted system. While it may help an individual to escape the taxation of his financial assets, I am not so sure how much that gives the system from an economic point of view.

But even if a reform is under way, there are two key reasons for incomplete markets, even in an advanced economy: the problem of imperfect information on one hand and the so-called principals and agents problem on the other. In a system of financial intermediaries it is very often difficult for the depositors to make sure, short of having deposit insurance, that their agents, the managers of the intermediaries, are going to do with their funds what they think they are going to do with their funds. These are problems that we are never going to get around entirely, and it is why we will not get complete markets in any of these countries.

As a result, if we had limited resources to devote to managing financial reform, it seems that we would want to focus on getting at the basic distortions in the financial system and let the innovations come after those basic financial distortions had been removed.

But innovation in a highly regulated system seems to me to be a less than productive use of resources.

Anthony Saunders: I also say, for example, that technology is highly related to efficiencies and information flows. If your argument is that asymmetric information is a constraint on financial innovation, then I agree with you perfectly. I think the degree of financial innovation is directly linked to the degree of asymmetric information, the degree of technologi-

cal sophistication, and the ability of the principal to monitor the agent, for example.

This leads to another story of why I say development banks fail. It is because they have a double principal-agent problem: the donor gives money to the development bank as his agent, and the agent then lends it to the ultimate borrower. So they have a double principal-agent problem. In a world with tremendous asymmetry of information, it is a tremendously costly procedure. Perhaps a more efficient procedure would be for the donor to lend to the borrower directly and directly monitor and supervise the borrower. So again I agree with you.

Technology is closely linked to information—as technology changes, so does the degree of information perfection in the market, and different arrangements become possible. Technology is a very important explanatory causal factor of different degrees of institutional arrangements and failures of institutional arrangements.

Promodh Malhotra: I think you have provided a marvelous framework for beginning an investigation into innovation. One of the things that I would like you to consider in future improvements on it is the demand side. So far we have talked largely of the needs of a financial system. We have talked of financial instruments. We have talked of the need for serving the interests of a securities trading community that does not exist and so on.

But to me there are two major important things here, and neither of them has been discussed: customers in financial markets and their needs. In any particular individual market, we will find that the customer is hurting for the lack of certain financial services or for the unavailability of certain kinds of funds at whatever price.

It is interesting that the success of finance companies and leasing companies has been achieved at prices sometimes twice those of the established banking system. Obviously the customer wants this money badly enough that he is willing to pay those prices, and even at the higher prices he is able to make a profit. Otherwise, he would not take it. So the second major need is the availability to customers of certain kinds of resources in a timely fashion.

In working with financial institutions in many developing countries, one of the fascinating things we have discovered is that systems and credit criteria are difficult to change. For example, I have worked personally in setting up leasing companies in about ten countries. The growth of leasing in lesser-developed countries is not primarily due to tax benefits, as most people think and the literature suggests; this tax benefit is the experience of developed countries. In developing countries small companies do not pay taxes. I do not care what the tax rates are. They just do not pay taxes. Therefore, high taxes or avoiding taxes is not the reason why leasing

companies are popular in these countries; rather that one does not have to put up money out of one's pocket to buy the needed asset.

Therefore, one much prefers to go to a leasing company, even if it costs more money, than to put up a 25 or 30 percent margin out of one's own pocket, as when one goes to a commercial or development bank. These are the more important kinds of reasons why financial innovations take place in developing economies. We as economists, however, with a foundation and knowledge base largely from developed economies, tend to transfer our preconceived notions and then look for causes that may not be relevant. Your framework I accept, but some of the—

Anthony Saunders: Wait a minute. I still do not understand what is the missing cause here.

Promodh Malhotra: The missing cause is the lack of change in traditional credit criteria. For example, if commercial banks were willing to change their credit criteria of wanting security for lending for fixed assets—

Anthony Saunders: That is because they have interest rate ceilings that do not allow—

Promodh Malhotra: No, it has nothing to do with interest rate ceilings.

Anthony Saunders: If you tell me there is a model where they have been allowed to charge interest based on risk premiums and maturity and they still have this preference, I would find that very bizarre if they are less-developed countries.

Promodh Malhotra: What I am trying to say is that you are employing a closed model with which you are trying to find relationships and coming to conclusions about why innovation takes place. I am suggesting that financial innovation in many developing countries takes place for reasons not related to those that are usually found in developed economies.

I am stressing that there are needs in different markets that are not being met by established financial institutions If these needs are strong enough, we will find the necessary innovations taking place precisely because the established financial institutions are not meeting those needs.

Anthony Saunders: Yes, generally, because of regulation.

Promodh Malhotra: It is partly regulation, but I am suggesting that even without regulation, you would find that there are credit practices that affect innovation even more. For example, you talked about trading, why a stock market is not developing in Kenya, because our traditional thinking when we look at a stock market concentrates on the needs of the stockbroker. So we say that we have to have a lot of trading. Unless there is a lot of buying and selling, not enough income is generated to justify the fellow's overhead cost. But I would suggest that the major problem in development of a stock market in a developing country is the lack of supply of securities. There are not enough firms that are willing to sell their stock

to outside buyers. Thus, when East African Breweries has a public issue in Kenya, it is oversubscribed many times. Why? It is not the lack of trading—

Anthony Saunders: Because of the Capital Issues Committee that regulates new issues.

Promodh Malhotra: The Capital Issues Committee can have an effect, but if you ask people why they do not sell their securities in these countries, they say, "I would be crazy to sell, because if I get my hands on a good stock, which is going to give me a good return, I will will it to my grandchildren; I am not going to sell it." But all I am stressing is that we also have to look at the demand side to understand why financial innovation is taking place.

Joshua Greene: As a follow-up to some of these comments, I wonder if Professor Saunders would want to comment on either of the following points. One is the role of capital flight in inhibiting financial innovation in developing countries, and the other is what the prospects might be for using credit unions as ways around some of these missing markets.

Anthony Saunders: I think capital flight can also create financial innovation. For example, Mauritius's offshore banking unit is a case where capital flight contributes to financial innovation. The idea obviously is to collect capital flight from other East African countries. In other words, capital flight can actually, as you say, dilute the wealth base of an economy and change the concentration of wealth, make it even more skewed to a few individuals, and therefore reduce the breadth of possible trading in that economy and therefore the benefits from innovation.

For the countries receiving it, however, it creates demand for new types of products, innovative types of products. For example, Mauritius is thinking of setting up an offshore insurance industry to complement its offshore banking industry. The country that loses wealth in the capital flight experiences a negative effect on its ability to introduce new products because of lost demand, but it also creates a demand for innovations in other countries. There is a global aspect to that.

On your second question, regarding credit unions as a possible way to bridge some of these missing markets, I think again that it is an information and monitoring question. Many sorts of new banks that have been set up in many of these countries have failed, mostly because of the difficulty of the central bank supervisory department in monitoring the actions, which in many of these cases led to insider runs and defaults and collapses of these banks.

Credit unions are a great idea if there is an appropriate supervisory agency with appropriate resources to monitor their activities and actions. It is a question of the principal-agent problem, as Donald Mathieson was saying. If the information flows are sufficient, then they are a viable process. If we cannot really monitor the activities of the people running the credit union, then it is a problematic innovation.

So again it is a stage. If technology advances and we have very efficient supervisors in the central bank or whoever is selected to monitor the activities, then they are a viable innovation, because they collect small savings at the local level and could be used for projects at the local level. The great problem is insider dealing and fraud.

Philippe Callier: There is one issue that has not been discussed at all here, and I am surprised. It is the role of competition, or lack of competition, in innovation.

I do not know what the role of competition is. One could argue that the lack of strong competition, as a result, for example, of the existence of oligopolies, may stimulate innovation somewhat because banks or a financial institution would tend to try to differentiate its products and engage in nonprice competition. Oligopolistic banks do not compete on rates, but they compete on services; and this may result in innovations. An example of this phenomenon would be the introduction of traveler's checks in Madagascar. One could also argue, of course, that competition helps in transferring innovations from countries where the know-how exists but where competition from outside is welcome or permissible.

It is probably difficult to give a definite answer to the question of the role of competition in innovation. Nevertheless, it would be a good idea to extend the scope of the study and to compare developing countries that are financially closed with developing countries where the capital account is relatively free. Such a comparison should help us to learn whether international trade in financial services has an effect on the extent to which financial markets in some countries develop and produce innovations.

-353-

Mohamadou Diop, Kenneth R. Locklin, Promodh Malhotra, A. B. Ndofor, and Lawrence H. White

12

Innovations and Markets in African Finance

Lawrence H. White: We have heard a lot about the question of "missing markets" and "missing financial instruments" in Africa. The question, of course, is why markets or products that "ought" to exist do not exist. In some cases, I suspect, their nonexistence is accounted for sufficiently by explicit legal restrictions against them. Other kinds of financial contracts may not appear in formal markets because of a lack of contract enforcement. In those cases it is interesting to look at how informal markets have sometimes been able to solve contract enforcement problems. There may be simply too little demand for certain sorts of products because there are not enough wealthy individuals.

If the nonappearance of a financial product is due to principal-agent problems or adverse selection problems, is it possible for state-owned agencies to solve these problems any better than private agencies? That is, if private firms cannot make a profit providing such products and services, is there any reason to think that state-owned institutions would do any better?

One theme that we have heard several times during the course of this conference is that we really do not know what the appropriate or the viable

set of financial institutions and instruments for these economies is or looks like. We do not know whether the appropriate markets to think about are national markets or regional markets, whether the appropriate institutions are big or small. One implication of this especially interests me: we do not know that it is a better idea to have one monopoly central bank, rather than a number of competing private banks, to issue the currency for these economies.

In such cases, where we are ignorant of the right set of institutions, we need to look to unbiased markets to reveal to us the set of competitively viable institutions. We need to allow market competition to act as a discovery procedure for evolving the right set of institutions. The innovation and selection of institutions and products are jobs for entrepreneurs, not policy advisers. The people on this panel, I hope, are going to give us their insight into what sort of institutions have passed the market test and into what sort of forces are operating in African markets to produce the results that have been produced.

Let me first call on Mohamadou Diop from the Afribank and then the other panelists in alphabetical order.

Mohamadou Diop: I speak from the perspective of a commercial bank with problems in mobilizing resources. We were challenged by market forces, let us say, with the challenge of increasing the amount of funds that we might mobilize from various market niches.

We undertook several market studies. We tried to see to what extent the type of products that are made available, the traditional products made available by the banking system in the West African Monetary Union (UMOA) might be increased. We also considered what kind of new products or new mechanisms might be introduced in order to have a net increase in the resources mobilized at lower cost. We did all of this with the knowledge that the money we sought to mobilize is in fact there, at some rate. The determination we had to make was of the rate we would be willing to pay.

We selected four target groups. One consisted of traders and other participants in the informal sector. I will come back to this group for most of my presentation. Second were the migrant workers. As you know, Senegal, Mali, and other UMOA countries have thousands of migrant workers in Europe who remit billions of CFA every year. The bulk of this remittance is accomplished through the postal system. Some of it is also done through some of the economic attachés of the embassies in France and in Europe and some—I cannot give you figures—by money carriers, people who are mandated by a group of countrymen from the same village or from the same ethnic group to take the plane and to carry bank notes with them for dissemination to family members in the country. That is one target group. I will come back to that.

A third target group was made up, generally speaking, of salaried people from the public and private sector—not a very big source of money,

but what we were trying to do was to introduce a new product that would capture a minimum amount of savings over a long period of time.

A fourth target group was special because it was really of more interest to our parent companies in France—the expatriate community in Africa, mainly the French expatriates and the Lebanese expatriates. By French expatriates I mean principally businessmen. By Lebanese expatriates I mean to include those holding dual nationalities (mostly they hold African nationalities and French nationalities).

Another group from whom we hoped to mobilize resources is the African upper class and other people suspected of contributing significantly to the flight of capital, mainly to Switzerland. Here, however, the target is not very clear.

So we have the informal traders, the migrant workers, the salaried employees, and the expatriate community. In our judgment the informal traders constitute the largest source of hoarded capital in the UMOA. I suspect this is probably true in other sub-Saharan African countries as well.

There has been a tremendous decrease in our sight deposits from the trading sector, generally. The structural adjustment process, especially the liberalizing of international trade, has resulted in increasing bankruptcies of firms and, therefore, a shrinking fiscal base from which the offices of our bank can draw resources. This has created a major preference for cash transactions in Senegal's economy. Everything is done by cash, including international imports, and this is the way it is done. In markets like Santaga and Medina in Dakar, traders pool together. These traders are usually from the same ethnic or religious group. Pooling their resources together, they would select one of their own to accomplish the task of bringing goods from abroad at the lowest possible cost—including the evasion of import duties—to be resold (with or without value added) by the traders in Senegal or for reexport.

The individual selected by the more affluent and sophisticated of these trading groups will, in one version of this process, go to my bank, for example, and open an account. Then the same person will go to France or to Italy or anywhere for the purpose of buying goods. For this to be accomplished as a direct cash transaction, without opening a letter of credit, only two things are required: the individual opens a bank account in the country where the purchase is made, and the purchased goods arrive in Senegal for the use (duty free) of the trading group's members. With the establishment of an account in France and because the transfer of funds is free between France and Senegal, he will transfer funds to the account in France sufficient for the intended purchase of goods.

The group's delegate will go through a French trader who will import the goods, say from Italy, and be paid in French francs. If necessary, the French trader will obtain all the necessary papers to buy on the foreign exchange; in this case, however, the Italian exporter will accept French francs in payment. On the other side, the French trader has accomplices

within the Customs Office or in some other way gets the necessary paper for obtaining his goods. These are goods on which no duties will be paid and for which the government will receive no revenues.

This process is growing in Senegal at such a rate that some banks have come to depend almost entirely on these types of transactions, though they are illegal. And though the process violates import regulations, there is very slight risk of detection—at least for the more affluent, sophisticated trading groups who establish the pairs of bank accounts and engage an established French trading intermediary. Most of the trading groups, however, are not participants in this nearly risk-free process for importing foreign goods, and their exposure to risk suggested the creation of a new financial instrument that would attract their business (and allow my bank to mobilize their resources) by reducing their risk toward or to the point of their more affluent competitors.

In contrast with the process (just described) that is employed by the more sophisticated trading groups, the bulk of intended duty-free importing is accomplished by carrying bank notes between Europe and Africa—not between France and the monetary zone but between the monetary zone and non–franc zone countries. They pay in cash, and because the CFA is convertible, the central bank gets back the notes from Switzerland, from England, and from other countries. In a recent seminar in the central bank, it was stated that the amount of CFA notes repatriated this way is close to 200 billion CFA. On a yearly basis, that is about U.S.$700 million. There are differences of opinion as to whether this U.S.$700 million represents commercial transactions. On the basis of my experience as a banker and on observation in the marketplace, I for one believe that the bulk of it is from trade transactions. Why? For Senegal particularly it is because we have neighboring countries that do not have convertible currencies, and I know that a great deal of the foreign trade of those countries, including Gambia, Guinea-Bissau, and Mauritania, is financed with CFA.

So what we tried to do was create a new financial instrument that would enable people to reduce their risk: instead of going across borders carrying money in a briefcase, with all the risk of being arrested by the police or of having the money stolen at gunpoint, we are going to sell *pied de parti* privilege, which is negotiable in any of our bank branches anywhere in the franc zone. This new instrument is similar to a traveler's check bearing a nominal interest rate of 2 percent. We think there is substantial demand for such a product in the community for which it is targeted, for what we are really selling is security and trust, and this is a bearer nonnegotiable instrument.

The central bank refused to allow us to do this because from its point of view this would just increase the capital flight outside the CFA countries. We argued that the type of capital flight they are talking about is something that is not unique to the CFA countries. It occurs all over the world. There will

always be little classes in all countries trying in one way or the other to seek refuge for their money. They refused with the exception of one country, Central African Republic, where we were able to sell 400 million francs of these notes within a few months. The buyers were mainly cattlemen who were having a lot of problems because they were going from border to border selling their cattle and usually carrying cash from the sales with them. Banditism had developed in those areas near Lake Chad. These people were losing a lot of money; so they jumped at our new product.

Our objective was to capture, let's say, between 20 and 25 percent of the float, depending on how long the purchasers keep these instruments beyond the minimum of approximately two months that we required before redemption. We are trying to sell this product in all of the franc zone, as I say, but are making little headway because of the regulatory constraints.

A second target group, the migrant workers, used to transfer money through the postal system. The franc zone has a monetary postal union, of which France is a member, whereby the various postal offices periodically compensate one another. But the postal system is now totally bankrupt, because some offices within the postal system were unable to compensate others. Whenever a country had been in the red, France would advance the money; but it reached a point where the postal system ran out of resources. In consequence, many of these migrant workers found themselves with a lot of money that they could not transfer.

What we decided to do was to open specialized monoservice branches of our bank. They would do only one thing: take money and transfer it. Many of the North African countries and even Senegal, with the Banque Nationale, also tried to meet the demand that had been served by the postal system, but they opened full-service branches in hopes that the results would allow them to do banking business in France. Of course, they lost a lot of money. They were not viable. They could not compete with the French banks, and the overhead costs of such branches were staggering.

In contrast, our monoservice branches are highly computerized, with three-person staffs (the head of the branch, a cashier, and an accountant). We guaranteed that francs deposited in these branches would be credited to the account of the migrant worker within twenty-four hours, and we were able to do it thanks to computer programming. That is all, almost. In addition, the staff were African. In my case and my colleague from Mali, we selected a staff that was multilingual so that any one of the three staff members could communicate in any of the languages spoken in the area. When a migrant worker comes in, he does not need to speak French; he finds people who speak the local language. Mali opened its branch in March 1986. Within a year it captured about five billion CFA. Within three years it had transferred over 12 billion CFA.

These two cases illustrate the kinds of innovations in financial instruments that my bank has engineered, why, for whom, and for what demand. I

will only touch upon our efforts with respect to the other target groups. For the upper class we provided what could be called trust fund management. It is very sophisticated but not really innovative. Besides, to be honest from a developing country standpoint, it is not a desirable thing to do because one is just encouraging people to place their money in overseas capital markets.

For the salaried we provided a traditional passbook savings account but linked it to future lending possibilities. When the account reaches a certain amount, the depositor is entitled to a housing loan of a given amount with a multiplier effect.

We also tried to open individual retirement accounts. This remains somewhat experimental. We are trying to sell them in both the Ivory Coast and Senegal. These are some of the things we are trying to do. But again, I want to stress that regulatory mechanisms really do prevent us from innovating more extensively.

Kenneth Locklin: I see relatively few of my colleagues from the private sector on the list of attendees. So, like my colleague from Afribank, I thought perhaps I could bring you a report from the front lines of the African financial sector.

As a merchant bank that has operated exclusively in Africa for the past fifteen years, Equator has struggled to develop and innovate where we thought it would be useful for our clients or the markets in which we worked. I thought that it might be interesting for the conferees to follow through a brief case history of the innovation that is represented by the Africa Growth Fund.

Our work on the fund began in 1985. It was, as you might expect, relatively academic work. We spent some time, as part of an ongoing pro bono effort, analyzing financial sectors and the projects in which we had been involved. We identified at that time a fairly regular pattern of projects we deemed to be worthwhile in financial terms, which were not funded.

Most often they failed to be funded because they were missing a particular block in their overall capital structure, and most frequently that block was foreign currency equity to support the project's costs. I am speaking here of larger-scale agroindustrial and industrial projects, typically U.S.$5 to U.S.$100 million in size. At the same time as it turned out, and unknown to us, colleagues of ours at the Overseas Private Investment Corporation (OPIC) were active in developing their own analysis of the African marketplace and the financial structures there and came to the same conclusion regarding the need for foreign currency equity.

Simultaneously, colleagues at the U.S. Agency for International Development were undertaking a similar analysis, an indication of how well people in the same area managed to communicate. The three of us were unaware that we were doing the same project at the same time. Today, I think, as Professor Saunders pointed out in the case of Kenya, it is relatively

widely accepted that there are limits on the available amount of equity and that the equity absorption capacity in many African markets is in excess of the available equity supply.

We took these insights, pooled the efforts that had been provided through OPIC and AID with our own, and spent the next year working closely with OPIC developing a structure for the fund that we planned, the structure that eventually became the Africa Growth Fund. The model for the fund was loosely based on a U.S. venture capital model, and I emphasize loosely. The fund was designed as a new investment vehicle that would raise equity capital to create, expand, or rehabilitate productive enterprises across sub-Saharan Africa. OPIC is now considering similar funds for other regions that it serves.

The fund's structure called for equity capital to total U.S.$10 million in the form of limited partnership interests, which would be offered to substantially U.S. corporate investors. Debt capital of U.S.$20 million was to be created through the issuance of promissory notes that were guaranteed by OPIC, these notes typically being sold to U.S. financial institutions. The fund was to be structured as a fifteen-year closed-end investment.

We were seeking to achieve long-term appreciation on the funds committed by our investors and, of course, a current return on our capital as well, primarily by investing in equity and principally equity-related securities of companies active in sub-Saharan Africa in a variety of sectors. The companies chosen for investment would be targeted specifically on the basis of their financial condition and their growth potential.

We were not constrained by any positive developmental requirements. The fund needed only to assure itself that the investments it was proposing to make did not have negative developmental consequences as defined by the OPIC development staff.

The fund was intended to purchase securities of both new and established companies, which might be planning to expand or modernize or significantly expand their capital base, and it could also be used to help implement privatization of a previously state-owned enterprise. We hoped to invest the fund assets in a fairly broad spectrum of industrial sectors—agribusiness, chemicals, construction, machinery and equipment, electronics, finance, trading, and so forth. No strict limitations.

When this concept developed, we began to approach the market and identified a major international investment bank that thought this an interesting project. The bank committed some very senior staff at the outset and as we went along increasingly more junior staff as it proved not to be an entirely successful enterprise for them.

In that process the investment bank determined that it would develop a prospectus and then market that prospectus to 200 leading U.S. multinational corporations. It marketed that prospectus somewhat in the way that one might market a limited partnership for real estate investments. We

produced, we think, a well-done prospectus, put it in the mail to the treasury department of the corporation in question, and then politely called up the junior assistant treasurer asking what his boss thought about this project.

The response from the 200 companies contacted was uniform, and, as you might expect, it was negative. There was not a single company that was interested in discussing this project beyond the stage of a first meeting, and only five of 200 were prepared to allow us the pleasure of visiting them at their place of business to talk about what we wanted to do.

The investment bank then stepped back and felt that it ought to tailor this fund. It proposed to tailor the fund in several ways. It would tailor it to be attractive to U.S. foundations interested in placing money in projects such as this—pension funds, which were sensitive to the requirements of the developing world, and what in the United States are called socially responsible investors, the investment funds that make sensitive investments in a national and international context.

Once again, just as with their first effort, there were no interested foundations. There were no interested pension funds. There were some pension funds that looked aghast when we suggested they should consider putting money in a place like Africa, and socially responsible investors were very interested in any investment that could be socially responsible while being absolutely liquid.

At that stage it occurred to us and to OPIC that we might have the wrong investment bank, and a new investment bank was identified. We analyzed our experience and at that point came to the conclusion—a conclusion really led by our experience with the investment bank—that we were not going to make any converts in the U.S. market, certainly not with a 100-page prospectus.

So the approach was shifted to focus on those U.S. firms that were already active in the African marketplace and, more important, were successful in the African marketplace, those firms that were maintaining or expanding their investment levels, rather than seeking to exist. In essence, what we were doing was admitting that it would be successful only with those companies that had learned what we were arguing, which was that private offshore investment in Africa could be conducted profitably. That is the approach we have been working with for the past seven months, and it has proved successful.

We have now identified a total of eight investors that have committed 55 percent of the original capital target for the fund. The fund had its first closing in March and expects to close out the rest of the equity before the end of the fourth quarter. The syndication at this stage is going relatively smoothly.

As of last week we were effectively operational, with in excess of U.S.$25 million in investment capital to commit. We are beginning now the

process of identifying the right kinds of investments to make this fund operate successfully over time. Perhaps we could all meet here in fifteen years and determine whether we developed an effective structure. I have the luxury at this point of not having to answer that question.

We have learned a number of lessons in this process, and that may be of interest to the representatives here. If we can presume that a fund structured like the Africa Growth Fund has a value in the African financial marketplace, it seems to us that we can draw several important conclusions.

The first is—and this is a point actually made by Professor Saunders—government sponsorship of innovations continues to be necessary in many African economies. In some cases the sponsorship needs to be external to government because the local economies do not have the resources to develop the information or the perspective to see the potential.

Clearly, this project would not have succeeded without support from AID and OPIC. Our investors have made it clear that without that support—financially, to make the leverage of the project operate and, structurally, to keep the project moving while it was being developed—they would not have been attracted to the investment. There is hope on all of our parts that there will be successor funds that can be placed in the public markets in the United States, but we do not believe we have reached that stage.

Second, the absence of the collateral instruments or structures that were referred to as one of the requirements for successful innovations has proved a real constraint to us in designing the fund, in an attempt to meet market needs. For example, we have found that the absence of functional stock markets in most countries on the continent has forced us to look to projects where individual investors are likely to have an ongoing interest in the project sufficient to purchase the investment interest of the firm at liquidation, because we cannot realistically depend on the sale in a free and open market. This obviously restricts the number of investments we can make.

We have also recognized that in the absence of mechanisms for a stable and relatively freely convertible currency, we are forced to focus on projects that have some level of export potential, because we have made the bulk of our investments in hard currency and we have to produce a hard currency return for our investors. As a result we miss whole sectors of profitable and economically valuable activity, which we simply do not feel we can seriously address.

Finally, the absence of local investment intermediaries, of local venture capital firms or other equity investors, or of commercial institution equity investors in the local marketplaces prevents us from engaging on a cost-effective basis with the supervision of smaller-scale investments.

That in turn has forced us to the determination that we will have to make quite a limited number of investments and thus in projects that are larger in scale and scope, again missing out on a number of private sector

opportunities that are financially very attractive and I suspect are likely to have the highest level of developmental impact as well.

With all of these compromises, we think we may have tailored a vehicle that will be successful in the market, but it certainly remains an open question, and we are no more confident than we ought to be at this stage. It is in the context of the continuing deficiencies such as these that we regularly encounter in African financial markets that the analysis and the projects that are considered to be undertaken by the agencies represented here have such importance to those of us in the private sector.

While I will admit that I and some of my private sector colleagues have complained from time to time about the initiatives or lack of initiatives by institutions such as those represented, the topics being discussed in this session have a great deal of importance for our success and for the success of local markets going forward.

Promodh Malhotra: At the International Finance Corporation (IFC), where I am manager of the Syndications Department, we have been involved in working with the financial sector now for about eighteen or nineteen years around the world, including in Africa. We have worked in a small way, and I have to stress that our work and achievements have been modest. But the successes have been quite striking, and I think we have learned some useful lessons. We have done work in the area of small-scale industry financing, leasing, development of finance companies, mortgage banks, venture capital firms, and improvement and development of securities markets.

During the initial period we spent most of our time doing the traditional financial sector surveys and prescriptions for solving problems in the financial sector. Our reports were received well, we got a nice lunch or dinner, and then, of course, the reports were promptly filed, and that was the last we heard of them.

We changed our approach in the early 1970s and decided that we would put our money where our mouth was and help create institutions that would do what we said needed to be done. One of the first lessons we learned was that we have to approach these markets with considerable humility, because development experts sometimes tend to treat developing countries in Africa with a degree of intellectual arrogance that is matched only by our ignorance of local operating conditions.

We do not have adequate information about how these societies and economies function, other than their most obvious part, the so-called formal sector, which is really the large sector, the one that is touched by the international economy, by the multinationals and so forth. But the real problems of financial development are not only the ones that are touched by this sector. We discovered in fact remarkable success stories in the so-called informal sector. I often refuse to use this term, because the sector is not informal; it is highly organized, very efficient, and profitable. It is just

not regulated. Because it is not regulated, central banks and other external experts denigrate it with the term "informal."

These so-called unregulated financial institutions do a darn sight better job than the big, formal, "Western style" commercial banks. Having said that, there is certainly a major need for modernizing and improving financial services and the technological skills that are needed to do a good job in the modernizing of society.

It is the process of modernization that I want to stress. These are not static societies. They are societies that are changing and moving, and we have to, in a sense, go with them. One or two speakers alluded to this earlier in the session, and that is a very valuable thing to understand—the stage of development, the movement toward change, and the study of the direction in which these countries are going. I would say that the first lesson that we learned in our work was that we must spend time and effort in listening to the people who are running the institutions in each society, not just the big ones that can be covered in a one- or two-week trip that people from overseas normally take. The second major lesson that we learned is that there really is no shortage of saving in these economies.

Related to their size, there are adequate savings, but reaching and mobilizing them, as Mr. Diop suggested, constitute the real challenge. It is not enough to set up shop and sit back and wait for the customers to come to us and then complain if they do not come. We really have to, as Mr. Diop's bank did, identify who has the money and then provide these people a service or a return that will be sufficiently attractive for them to entrust their savings to us.

There are savings in Africa as in other developing countries. We just have not reached them. We have not learned how to reach them. That is the third major conclusion that we have come to from our experience. These societies are in a process of change, and economic development is taking place. Adjustments are taking place, partly as a result of the adjustment policies suggested by external institutions and agreed to by the governments of these countries. As a result of these actions, the financial needs of different segments of these societies are also undergoing rapid change.

The problems that we see are that existing financial institutions, partly for regulatory reasons, partly perhaps because of the human unwillingness to change quickly, are not adapting fast enough to the needs of these different groups. So there are market needs that are not being met or are being met by impromptu improvisations like the ones that Mr. Diop suggested earlier.

It is an understanding of the needs of the different sectors in the market that we recommend be fostered. We have learned to our advantage that this will lead us to understand the need for different types of financial institutions and then, of course, finally end in the design of these institutions. Perhaps we should use a word other than "innovative," because, as

someone very rightly suggested, what is innovative about it? It is old hat. It has been done in a hundred other countries; so what is innovative about it? Let us say we should develop "market-oriented financial institutions," or "need-oriented institutions"—those types of financial institutions or instruments that help the individual users get the resources they need, at a price they are willing to pay, which then obviously leads to economic development and improved general well-being.

We believe that, at least in the foreseeable future, there will be an increasing need for designing specific kinds of institutions to meet specific needs. One of the other lessons that we have learned is that we should not try to set up financial institutions that are going to compete with commercial banks for the basic deposit mobilization of savings. Mr. Diop gave us a unique example of the very keen understanding of this market difference in the countries of sub-Saharan Africa. He also gave the examples of the traditional approach of setting up a full-service commercial bank. It is important to understand this, because we all are chasing the same savings, but in fact, that is not what is really needed. In innovation or meeting the needs of people, we need specialized lending skills, understanding the needs of a particular market segment, whether it is agriculture, industry, trade, transport, or whatever. Then, because of our understanding and skills in that area, we become specialists in lending to that particular sector.

To be successful, we have learned that it is better to borrow wholesale and lend retail than to borrow retail and lend retail. One of the lessons certainly Asia, Africa, and Latin America should learn is that housing banks should not pattern themselves after a traditional savings and loan, because shirts can be too readily lost that way. Instead, such institutions should borrow wholesale from those institutions that have already mobilized primary savings and that are not doing a very good job of lending those savings. Take it from them on a wholesale basis and then lend retail to a focused segment of the market that they understand and know very well. This also means creating a very useful link between resource mobilization and allocating institutions. This complementarity could mean a great deal. It could also reduce the overhead costs of the financial sector considerably. The biggest overhead cost is in mobilizing primary savings.

We have also learned that it is vitally important not to destroy local indigenous financial institutions and instruments. I fear that the general tendency of large international organizations is to do just that; to dismiss them by labeling them "informal" and, therefore, inefficient and to say that what we really need is exactly what we have in London, Paris, or New York. We find, in fact, that in the lending arena these local institutions are unique and most efficient. They have much lower loan losses, and their arrears are a minute fraction of those at the wonderful, modern financial institutions that we have created. The reasons are social. People pay back loans because they feel they have to pay back loans. If you have a feeling that you are

dealing with an impersonal government organization whose employees do not really care whether you pay back or not, the tendency is to say, "Why should I pay?" Of course, in some countries, there are politicians who encourage this attitude to gain cheap popularity. They say, "You don't have to repay. What are they going to do to you?"

In the same countries, however, we find that the informal institutions, because they are based on local social systems, have a social sanction that cannot be escaped. I will never forget my first lesson in this, from a banker in Kenya, who told me in 1974 of the difficulties of realizing security for a loan gone bad. His bank had made loans in the highlands of Kenya to people for various purposes, and they had traditionally taken security over the *shamba*, which is what they call the ancestral home of the borrowers. For various reasons, a loan went bad. The bank had a situation where it had to go and realize the security. It had all the legal rights to do so. The bank held an auction and no one came. Of course, it was very simple. The local social group just got together and said, "We will fix the outsider." The bank then changed its approach and obtained community guarantees for making their loans; their loan losses dropped sharply.

We have also learned that there is a very major problem of an adequate supply of human and technical resources that needs to be addressed and perhaps has not been given the priority that it needs—managerial training and things of this nature.

In the area of stock markets and equities, we fully support the views expressed by various people that there is a great need for their improvement. Our experience is that their slow emergence and growth are due not to a shortage of money wanting to invest in securities but to a lack of supply of securities. If there are good companies coming to the stock market, there is not a dearth of investors in most developing countries.

Finally, we have learned that in the developing financial markets, it is the identification and support of new entrepreneurs who have already had some degree of success in their small businesses that is vital to enhancing further growth and development. This is an area on which we feel that financial institutions should especially focus and from which good results should be expected.

A. B. Ndofor: As manager of the Cameroon Cooperative Credit Union League, I would like to offer my own experiences with the credit union movement and also with some of the systems commonly described as informal. Particularly, I would like to say that tontines have developed in Cameroon quite a lot. My fear is that we have been approaching this system of financing as if it is a new creation, rather than what has been there, and also that it is a static system and immune to change in the community, which is not entirely true.

I think one reason for the continued existence of the tontine, or the *djanggi*, is its dynamism, its ability to adapt to change and to find its way

through different systems. The *djanggis* in Cameroon have been evolving, and they have taken different forms. Some of them are created to meet specific financial needs. At this point I would like to say that I am also approaching this subject from the belief that people are endeavoring to save money that can assist them at a later date.

It is not because they want credit that they organize. It is the reverse. They want a way to make sure they have some money saved for the future for specific purposes or to do something. This becomes very, very true with the systems that could be described as the rotating savings and credit associations (ROSCA). In them a number of people come together and agree to save on a monthly basis, and someone among them is given the savings each month, because they have a project at hand to finance, while others agree to take the savings later. During September, for example, many would like to take ROSCA savings and pay school fees. Others would like to give up their places for people who want the money. The first reason for coming together is to build up savings and not necessarily credit. As I said earlier, however, the system is evolving, and people with investment needs, people who see profits in putting money in one form of business or the other today, want also to join the tontines or the *djanggis* in order to obtain credit, cheap or at a high cost, for the purpose of investing now for profits later.

This is, again, another element of the *djanggis*, which is very, very important. Sometimes the cost is implicit. It is not a direct cost, because sometimes the people do not actually pay any interest. The interest is calculated on the volume, the amount of entertainment that the people give. This type of *djanggi* or tontine is common not only in Cameroon; it is available in Nigeria, and it is common in the whole of the West African coast. Large sums of money are raised in some, and very small amounts of money are raised in others. These savings or the credit obtained from these savings is employed in different ways. As the people meet their primary needs, they begin to invest in other ways.

In the system there is peer control, which ensures that any loss due to the failure to repay loans is very little. The people themselves will bear the risk of loss resulting from nonpayment of loans. They compare the risk and the returns they get from their investments. Sometimes they share interest or dividends resulting from the loans given out during the period.

I do not think I have the time to describe the various systems, but these systems are really very common, and they raise a lot of savings. I have found also by coming in contact with other African countries that unfortunately the tontines and *djanggis* do not exist in East Africa and even in the southern part of Africa as they do in West Africa, but still there are informal systems of financing. In Kenya and Tanzania the Indians have a way of coming together and financing the businesses of others, formally or informally. In Zimbabwe the savings clubs have been known to raise a lot of savings, which are used in various ways by the members.

As I say, I am approaching this subject from the side of making the savings possibility available to the people, and I share the views just expressed by Mr. Malhotra that the presumption that the whole of the African continent is capital dry is mistaken. Since the money economy was introduced, people have learned that money assets can also generate income, and quite often they want to use this. The most recent arrival on the scene is the cooperative savings and credit societies, or what are commonly called the credit unions. In the past two decades quite a number of these societies have been established in at least twenty-five countries in Africa. They have put tremendous effort into the mobilization of local savings, meeting with varying degrees of success.

In Kenya the savings have grown only within the civil service because the credit unions in Kenya are mostly among the civil servants; they have so much savings now that they are beginning to divert or to use those savings in real estate. First of all, the individual members borrow the money for their own houses. When members' immediate housing needs have been generally met, the society itself begins to invest a lot of its surplus, liquid funds, in real estate, in buildings, in the city of Nairobi. Within the city five or six credit unions have built houses and are now renting them out.

This indicates that there is capital there. The question is how to organize that capital and how to get it properly used so that it will pay the owners of that capital well. Here I cannot avoid taking issue with some of the people who say that there is no capital but at the same time talk quite often about capital flight. I am forced to ask, If there is no capital, where is the capital that is flying out?

That is the issue. Then the question arises, Why is there capital flight? Is it because the interest rates are too low, or is the capital flying for safety? One reason or the other. This brings me to the policy issues that are involved and that I think should be considered in financial policies; these would include the legal framework within which any financial system should evolve. I believe, again, that any financial system should be allowed to evolve on its own and not be expected to emulate other, more sophisticated systems such as the New York or London stock markets. It should not be compared with these other systems, but we should be looking toward providing a legal framework within which the existing financial system can evolve.

The next policy issue is that of microeconomic policies: how can this money be invested? Again, one hears the accusation in some developing countries that banks are not lending long term. Why are they not lending long term? What would they be lending long term for? Most of the economy is a trading economy. They buy and sell. Why do the traders need long-term capital?

If industrial development is desired, people's investments will allow that in stable political environments. The need for stability brings up the earlier discussion of inflation. Inflation, caused by whatever means or

factors, erodes the value of money. To an extent it also discourages savings, increasing the propensity to consume; if one wants to get satisfaction from the money one has—and I think many people like to do just this—it is necessary to be sure that whether the income is spent today or tomorrow, the value will be approximately the same. I have seen that during the time when the economy was growing with little inflation, people saved more; they were willing to put the money aside because the next day they could get the same real money.

In discussing monetary policy or financial policies, we should look at these issues. Again, I also want us in particular to look at credit as something that we want to supply to the rural people; to say, "Here is the money for credit," rather than merely asking, "What is the demand for credit?" Credit for what? If there is that demand, we want to meet it from various sources and possibilities, which include the people's own savings.

Very briefly, another system that I have witnessed supports people's need for savings instruments. It is what we call the daily contributions, which are common in West Africa, especially among the market women and the small traders. It is common in Nigeria, especially in the west, and common in Cameroon, where people actually pay others to keep their money for a short time. After the day's sales, somebody comes around to the market people and picks up the money for safekeeping; the trader collects it when he or she wants and pays a fee for the safekeeping. In Cameroon the commission is about fifty francs per thousand saved for the duration of a month.

The question is, Why do the traders do this? It is the convenience of having these people take the money and bring it back to them when they need it. I heard this morning one of the banks in Washington say that there will be no more queues. You come in. We serve you and you go. Time is money, and what is happening is, in Africa, at least in Western Africa, where queues do not exist unfortunately . . .

[Laughter.]

. . . it is not realized that people are anxious to use their time profitably. They come even to the commercial banks, and they eventually have to beg the bank clerk to accept the savings. This is the problem. We in the credit union movement over the past decade have tried to overcome this problem of convenience, and a lot of savings have been mobilized. The problem in doing this, in getting this fully accepted, is the ability of the credit union system to put in managerial systems that would ensure the control of the money and the correct investment of the money. It comes back to the question of managerial skills, even in rural areas.

Managerial skills are very important for any financial policies to work because these policies have to be carried out by people with a knowledge of finance; money itself is not the goal. It is what the money is used for—for productivity—that matters most. We talk quite openly in inquiring about

the parastatals or the public enterprises as being the main source of creating surplus money because they get it from the treasury. I am asking, What is the productivity of these institutions? Do they give to the taxpayers or to the public their money's worth? Could such enterprises be financed on commercial bases, through the money markets or capital markets?

The credit unions have evolved to provide capital to small holders, and this capital is accumulated through savings of members. We have seen that from the beginning the loans are meant to meet very short-term needs. But as the savings grow, people begin to find themselves with a bit more capital and are willing to take more risk. Only when they have their own capital base are they willing to invest either longer term or in riskier ventures.

Discussion

Ulrike Wilson: I thought the description of the tontine system in particular but also the others were very interesting. I would like to know a little more about the links among different tontines and also between them and the more formal, established banking system. Since you mentioned credit unions in Kenya making investments in real estate, could these same groupings perhaps also make some investments in productive activities?

A. B. Ndofor: With savings built into the system and with the bulk of the money being given to an individual who then invests it as he or she wants, the tontines enable each of the possibilities that you raise. Sometimes the money is kept in the banks; so there is certainly that link. Some of the tontines are now evolving into what may be most accurately described as investment trusts. Some of these have become mutual funds or money market funds. But accurate knowledge of their activities is mitigated by their secretiveness—part of which reflects a simple desire for privacy. This is understandable. People in Europe and America, for example, would be discouraged from nosing into the activities of private companies by the owners of those companies. Yet the members of tontines and other private associations are often criticized for being secretive. They are actually protecting themselves.

But some links are very clear. Many tontines deposit their saving in official sector banks. The system is not completely self-sustaining, however. In Cameroon, for example, there are problems with liquidity in the banks, and the links are weakened by people hoarding their money in order to be

sure they have liquidity. If the environment is right and the policy is correct, I do not see any reason why credit union money cannot be channeled into productive or long-term production enterprises. In fact, those well-organized credit unions are having a problem of how to invest money other than in the commercial banks. How else can they invest the surplus liquidity they have?

Promodh Malhotra: Why do we consider investment in real estate not productive? Since I came to live in the United States, I have found that there are two engines of economic development, the housing industry and the automobile sector, because if you build a house, you need cement. You need labor. You need a million things. You need to put furniture in it. You need to have soft goods.

To me housing in the developing economies certainly should be considered as productive as it is in developed societies. But I found that economics has a strange ambivalence in this area, and I think theoretical economics is particularly vicious. We need to change that.

Mohamadou Diop: There are two reasons that I can see for the extent to which the tontine system exists in Senegal. The two reasons are basically sociological and psychological.

One is that the people who enter into the tontine associations are from the nonwesternized fringe of society. For diverse reasons they do not trust the educated elite who manage the banks because of the appearance of corruption and the appearance of economic laxity. Most people simply do not trust the banking elite in Africa, because the banking elite is at the top of the salary ladder. The best-paid people are the bankers.

Another sociological reason for the tontine is indicated by the fact that their members, like my mother and my sisters, are mostly women. One of the reasons that women are obliged to participate in tontines is that men frown upon women's having financial independence. When a woman has savings, she does not want her husband to know. I have had instances of women trying desperately to get an appointment with me from their children who are employed by the bank. Upon meeting with them, I have been flabbergasted; they have had millions in savings accounts in my own bank, but their kids did not know it. One of the reasons that I was getting all these requests for appointments was that the women had heard about what was going on in the banking system. They were worried, but they did not want to ask their own children who were in the bank and thereby reveal their own savings accounts.

Promodh Malhotra: It is interesting that Africans who are not very modern or sophisticated in that sense are very sharp financially. Smaller farmers and others with whom I have had discussions know that when their savings go to a formal bank, the government, in their words, steals 30–40 percent of it. They say that their money that goes into a commercial bank,

through required reserves and other nice euphemisms, is taken by the government and, in their view, squandered and misspent.

There are individual savers who say, "I don't want to give my money to the government. I don't think they know how to spend it." It is fascinating. It supplements what Mr. Diop is saying about the lack of trust of government banking.

Mohamadou Diop: What you report echoes our experience with the migrant workers. When we did our market study, the first question was, "Is your bank a public sector bank?" I was very surprised. This was the first question, and we had to emphasize that we were a private bank.

A. B. Ndofor: I agree with that comment about the common man being very sharp in finance. One reason why people hold some forms of assets or keep their savings in other forms of assets is to fight inflation. Instead of keeping the money in liquid form, they will buy, for example, a small cow and keep it behind their house to grow.

As far as the tontines are concerned, they are not only an issue of the rural areas. There are urban tontines, and in at least some parts of Cameroon almost everybody, no matter the level of literacy or the position he or she holds in society, is in one tontine or another. I want to add that the tontines have a social function, too, outside the pure economics of it. They are widespread, and each has a very different clientele, and each one caters to its own clientele.

Carlos Cuevas: It seems that most of the innovations raised in these discussions relate to individuals' reallocations of financial savings from one portfolio to another—locally or in foreign countries. This is quite different from innovations that would tend to reallocate physical assets and savings to savings in financial form. It seems to me that in this latter area there are not many innovations. It appears that depository institutions such as the post office savings still have essentially the same two instruments offered to the public since before independence—the passbook savings account and another retirement kind of savings instruments. Likewise banks have essentially passbook savings and one or two variants of time deposits. In that area I do not think there are many innovations to speak of.

On another point, I got a little nervous when Mr. Malhotra was talking about the specialized lending institutions and borrowing wholesale and lending retail. I do not know if that is what he had in mind, but it reminded me of the large development banks whose outcomes have become too familiar to all of us over the years. I do not think that is exactly what he was talking about.

Promodh Malhotra: You are right. I did not have that kind of institution in mind, because then there would be what I call politicized lending, for which there can be no market test. When it becomes known, as in the examples you cite, that a government has decided that a given

amount of money must be lent and there are lending targets but not particularly credit-worthy customers, the loans are going to get made anyway, because there is an organizational need to make the loans.

In contrast, what I had in mind was institutions oriented to the private sector, profit-making institutions that will lend money only if they know they will get it back and also have a little extra to give to their shareholders. They will apply much stricter tests than the ones that are made by what I call, if I can use the word, development-type institutions.

Nonetheless, the bad press that the development banks have received, almost universally, is largely misdirected. Two things happened that were not expected when the earliest loans of the development banks were made. In fact, if we look at the files of the individual companies that were examined by the banks at the time the loans were made, the banks conducted very good, sensible analyses for eight- to ten-year loans. What could not be predicted was the total disaster in terms of the external values of local currencies and the general inflation, partly assisted by irresponsible fiscal situations.

I would hardly say it is fair to blame development banks for the fact that in a country, X, some poor company that had made an assumption that the relationship between its external debt and the local currency was to be based on 5:1 suddenly finds that the valid ratio is 20:1. Because the items produced by the company are being sold to not very affluent people, the price of the product cannot be increased four times to generate enough local currency to meet foreign exchange obligations. In these circumstances many companies have gone bankrupt, their liabilities winding up as worthless assets on the balance sheet of the development bank, which itself then begins to go bankrupt. After all of this the development bank is told what a bad job it has done. I think the blame, in fact, if I were to put it anywhere, would be on the managers of the economy who have it in their hands to control the external value of their currency. If they are irresponsible, they should not be blaming development banks and other financial institutions.

Kerfalla Yansane: I would like to come back to what Mr. Diop said. It is true that Africans do not trust banks, not only because of corruption but also because banks are modern institutions. That is true for banks, and it is also true for justice. Africans prefer to make justice in the village, instead of going to the modern courthouse.

When our state-owned banks in Guinea were closed, we called foreign banks. When these foreign banks came, many businessmen, not well educated, came before the banks and tried to open accounts. They would bring money in the morning, deposit it at the bank, and in the afternoon come back to ask for the money—to assure themselves that the money was still there. Some of them liked to have the same notes that they left in the morning.

[Laughter.]

That explains that we have to think again about banking in Africa, about the language and modernity of banking, and to take time into account, because, as said by our friend from Cameroon, Africans value time and want to act very quickly.

J. O. Sanusi: I think the impression has been created that Africans try to avoid banks. I know Nigeria is a very substantial part of Africa. In fact, we say that at least one of every five persons who are Africans is a Nigerian.

To this extent, I think I can speak on what is happening [illegible] very large part of banking in Africa. I have listened to the descriptions about the traditional methods of loans and advances; what they call the tontines of East Africa are what we call *esusu* in Nigeria. They do exist in Nigeria. They have been a traditional way of mobilizing resources and lending money.

Our experience in Nigeria is that these traditional ways are prepared to give way to the modern. In Nigeria we had a system that we called the rural banking scheme. This was introduced by the Central Bank of Nigeria with the support of the government. What we do in that rural banking scheme is what we know most other banks are not willing to do, because their business in rural areas, at least initially, would be unprofitable.

We know that some of the banks that exist in the modern urban areas are making enough profit to provide leverage sufficient for them to operate in the rural areas. So what we are now doing—in the third phase of the rural banking scheme—is to allocate, at the beginning of a four-year program, a certain number of branches in certain rural areas specifically to some banks and obligate them to go there. They are reluctant to do this, but they must, because there are sanctions that can applied if they do not. Under this scheme we have so far been able to open about 800 rural branches in Nigeria, which are allocated according to the size of the banks. The rural people have responded very positively to these banks.

You would be surprised at the amount of deposits that can be generated from some of these rural branches. In fact, some of the banks are discovering that some of the branches that at first were unprofitable are now breaking even, and some are becoming profitable. The types of informal financial arrangements that have been very ably described by my friends in these discussions and that still exist in certain parts of Nigeria exist in most cases because alternatives are not readily available.

I know that inefficiency in some of the banks, the time it takes to attend to customers—especially in rural areas where they do not have mechanized banking—and the realization that time is money are constraints to some people going to the banks.

There is, however, a very real difference between saving money in a bank and saving in the *esusu* system that should be noted. In the *esusu* system a group of friends have agreed together that they are each going to be contributing, say, a hundred dollars a month for savings purposes. There

is a compulsion, because of this agreement among friends, that whatever you want to do, you make sure that you contribute your own hundred dollars, because there are ten of you. Therefore, there is a thousand dollars that is going to be given out in turn to each member of the group at the end of each month.

In contrast, if you have committed yourself to take the hundred dollars as savings to a bank, sometimes, if you have to do something different, because there is no real compulsion you might say, "Okay, I will skip saving the hundred dollars this month." But in the *esusu* system there is this compulsion for the people to make the monthly contribution for fear of disappointing other contributors. It is interesting, however, that what is done with the money under the present system, even in the rural villages that I am talking about, may be to deposit it in a bank. That is, when the hundred dollars each is collected and given to one of the contributors, what he does in most cases, if he has nothing immediately to do with the money, is to take it to the bank.

What we have discovered does not really support the view that we are afraid of the banks or that we do not want to use the banks. Our experience in Nigeria appears to be quite different. I know the banking system in Nigeria is very much more developed than in some of the other African countries, but I believe that basically, if the banking facilities are available, people will not run away from them in preference to the traditional ways of mobilizing lending resources.

Donald Mathieson: I just have a couple of questions, since I am not familiar with the extent of these institutions. First, I think it is quite useful to have a flexible financial structure at any stage of development, and the so-called informal market strikes me as one way to get that. But in discussing this with people, I have never been able to get a handle on a couple of issues related to this kind of structure.

One is the question of how important in relative size these arrangements are for the economies, how much of savings they mobilize. That is one thing I do not have a good feel for. The second thing is how viable these institutions would be if restrictions in the formal sector were removed and if stable macroeconomic policies were put into place. Again, I do not have a feel for that. Then there is another thing that I focus a lot on in my work in industrial countries, which is what I might call the prudential aspects of all of this.

I understand the nature of the regional relationships that may exist and help in the enforcement of contracts, but I wonder what would be the prudential implications of expanding this informal market. Are we dealing with systems that ensure what I would almost call pathological honesty, or do we have the standard problems where considerations like fraud and mismanagement can enter into the process? In the course of these discussions, a lot of emphasis has been placed on the fact that these are

relatively closed or secret arrangements. I just do not have a feel for how these are monitored, if at all, and if it is important that they are monitored.

A. B. Ndofor: As far as the size is concerned, it is very difficult to give figures, but one would get an impression by examining the projects that have been financed by these local savings associations. As I said, substantial real estate and houses have been either bought or built. In addition, trading and other small companies have been financed, at least in their initial start-up, by these savings.

Another indicator of the substantial size of tontine savings was a recent interview with the minister of finance in Cameroon that appeared in one of the business weeklies that I read. The minister was complaining about how much savings the tontines take away from the formal financial system.

As I said, we should regard the tontine system as a dynamic system, not as a static system that will suffocate upon the removal of financial regulations, especially when it is not working completely in isolation from the formal banking system. I think the tontines will continue even if those restrictions on the formal system are taken off, but the magnitude may not be the same.

On the enforcement of contracts, I would say again, as I said earlier, that they are evolving. Some of the tontines now have bylaws drawn up by lawyers. Again, that shows to what level they are developing. I have actually seen by chance a bylaw drawn up by lawyers. The philosophy behind it, as someone described to me, is that the *djanggi* money takes priority over even emergencies in the family, because the *djanggi* money is a promise made a long time ago. One knows it and ought to have it ready when it is time to pay. The bylaw I have seen read thus:

> If the day arrives and your son suddenly dies, what we want to see is your envelope with the money together with the message of the loss of your son. When we shall have counted the money and given it to whoever is taking it that day, then we will make a plan how to come and sympathize with you over the death of your son. Unfortunately what is impromptu is the death of your son and not the djanggi money and so it has to be on the table as nobody fails the djanggi.

I have heard of cases of tontines accepting land titles as securities for granting certain loans. Therefore, I am inclined to conclude that these contracts can be as legally enforceable as any other contract made under normal regulations.

Promodh Malhotra: You have raised a very interesting question also of the integration, perhaps, of these institutions with the banks. I had a fascinating discussion with the chairman of the *esusu* association in Ghana, which is very similar to the one in Nigeria (in fact, a lot of Nigerians are involved in this business in Ghana). The chairman was saying he would dearly love a relationship of a lender of last resort with a larger commercial

bank. He was willing to submit accounts, he was willing to keep his cash with the banks, and so on and so forth. There is that realization that they can be of help to each other. But the fascinating thing that I think we have to learn is that they are customer oriented in a way the commercial banks are not and they are also very low-cost mobilizers of resources.

The social collector of the *esusu* goes from house to house, contacting the housewives, picking up very small amounts of money, bringing them in at the end of the day; then they are pooled together. I suspect that the commercial banking system is not going to be able to do that for at least thirty or forty years. If we begin to look at these as complementary systems rather than as competing systems, I believe that the financial systems in Africa will be greatly strengthened and assisted. I hope that the customer-oriented attitude of these traditional systems might rub off on the less responsive modern institutions.

Joshua Greene: I wanted to get back to the issue of missing markets because there was something that was said with regard to the Kenyan credit unions that I think is applicable here. Probably, before there are lenders who are willing to invest in small-scale enterprises, there must be either a large enough pool of funds or people in a strong enough financial position that they are willing to accept a certain amount of loss, because these are inherently risky operations.

If I were a part of a credit union that was just getting involved, I would want to invest in real estate for the very same reason. It looks much safer than financing someone who claims to have the next fantastic invention in that country.

This suggests that one needs to know and analyze the workings of entrepreneurial financing in other regions. Here some anecdotes may be useful. I think for example of stories of how some of the old clothing factories in the United States got started around the turn of the century. Immigrants would pool their funds, much as in the tontines, the ethnic enterprises mentioned here. Each one would contribute a small amount that he was not too worried about losing, but there was a chance that it would pay off, and then everybody made some profit. It was a very closely policed operation, and it happened entirely outside the commercial banking sector.

Another example of entrepreneurship financing comes from Taiwan, where land reform apparently led to the acquisition of large sums of money as people sold off land estates. There individuals were sitting on large piles of capital that they were willing to risk.

We may need to look at these sorts of things in order to see how we can organize institutions or help individuals in Africa do this same sort of thing. In the same way I have talked about how commercial banks finance this in the United States. Probably this part of the activity is not a large part of the

bank's overall loan portfolio. If it were, there would be even more bank failures than there are.

Perhaps we can draw on this kind of information and do some useful research to address this issue.

Parker Shipton: As Mr. Malhotra suggested, it is futile to ask whether tontines are better than banks or vice versa. They often serve complementary functions. Certainly tontines deserve the admiration expressed here, particularly the elaborate Cameroonian ones. They seem to be especially useful for starting up small enterprises, for providing household goods, for doing other things feasible at any time of year.

What tontines cannot do well is provide inputs for rain-fed agriculture. The problem is the covariance of supplies and demands: everybody wants to deposit at the same time of year and then withdraw at the same time of year. The lean season challenges tontines. In Gambian and some other West African settings, as we noted earlier, every year some tontines stop functioning until harvest time. But even then a tontine cannot pay out to everybody at once. This task may be better suited to an international bank that can shift resources seasonally between countries.

The question has been raised about the geographical distribution of tontines. They have been noted in patches all over the world, Africa included. In many countries they appear in both cities and countryside. They seem to be spreading within both East and West Africa and perhaps in southern Africa as well—which may, of course, be partly because researchers' eyes are opening wider to them.

381

13

J. Clark Leith

African Financial Sector Research: A Conclusion for Today

I begin with a few words about the role of the financial system in development, discuss the nature and consequences of existing systems, then address the question of reform mongering a bit, and finally turn to the process for financial sector research from this point.

Let me begin then with a few comments about the role of financial systems in development. In this respect I know that I shall not be saying a lot that is new, but it will set the stage for what follows.

There are three services of the financial sector that are identified in most of the literature. First, and in many respects the most important, is its provision of a means of payment and settling transactions. The efficiency with which this service is provided is important for the smooth functioning of any economy. Indeed, what I found impressive in the case of Guinea was how important that was, how quickly that function recovered, and how quickly people were willing to put their money back into the financial system to work because they found it so important.

The second basic service is simply to provide finance to units that have profitable investment opportunities but lack sufficient funds for pursuing

them and at the same time to provide profitable uses for others who possess surplus funds. Very simply, this increases the productivity of both.

Third, the financial system provides savers and investors with different yield, liquidity, and risk characteristics, again enabling both to match their requirements on these other dimensions. There are many dimensions to the desired characteristics, not simply the rate of return.

There was some discussion early in this conference regarding just what it is that these kinds of services do in the economy, what sort of analogy we should be using. I have been thinking of the financial sector in an economy much like oil in a machine. A well-oiled machine functions smoothly and efficiently using a minimum of energy in the performance of its function. Putting more oil on a well-oiled machine is not going to make it work better. Depriving a machine of the necessary lubricants is certainly going to result in wasted energy in overcoming friction, preventing the machine from operating as efficiently as it could and ultimately leading to a breakdown of the machine. The absence of a working financial system leads to this sort of breakdown.

There really is an optimization problem here, but it is not a usual kind of optimization problem; we have to be careful to avoid assuming that simply putting more and more effort and resources into the financial sector will somehow make the rest of the economy function better.

Let me turn to the nature and consequences of the existing systems. I start here simply because we do need to know how the existing systems work. Do we fully understand the implications of the existing systems? There is a good start in the 1989 *World Development Report*, and Jo Ann Paulson's paper provides us with an excellent survey in the African context.

To justify a serious investment of time and effort and research funds in reform efforts, we need to understand the suboptimal consequences of the existing systems.

There is first of all the basic means-of-payment function. Provision of this service seems to have a very high payoff. But care should be taken that not all the ills in the African economies are attributed to failings of the financial systems. Many of those ills are due to such other underlying reasons as the lack of investment in human capital, the absence of well-trained people, and the real distortions in the economy.

As was suggested earlier, often these real problems show up in the financial sector. They show up in the balance sheet of financial institutions, but they are nevertheless primarily attributable to other kinds of problems. So when they show up in the balance sheet of financial institutions, let us not shoot the messenger. Let us try to understand what the fundamental source of the problem is and move to deal with that much more fundamental problem.

In looking at the existing system, a second area we need to try to understand concerns the particular demands for finance that are being

frustrated now. Is there really a serious lack of long-term financial instruments? Is that lack frustrating real potential long-term investments?

Quite frankly my impression is no. Certainly in Botswana whenever a major long-term need was identified, we had no problem finding finance for it; the real problem was finding genuine long-term investments that would have a payoff. That may not be generalizable elsewhere in the continent, but the question has to be asked.

Where there are arbitrary sectoral allocations of credit, is there evidence of vastly different marginal returns in those kinds of situations? There must be such evidence to justify a major investment in trying to unify across those different sectors.

Third, on the savings side, are savings really being frustrated by the way the financial sector is operating? Repeatedly there have been suggestions in this conference that savings do not seem to respond to real interest rates, savings in the formal financial sector at least. Is that evidence, instead, that the financial sector is so alien to the real savers in the economy that they are unwilling to participate in it? Or is it that there is simply no responsiveness there? Much of the evidence from the informal sector that has been provided in these proceedings suggests that there *is* a lot of saving going on in African economies.

A fourth area of the existing systems that warrants better understanding is the interaction between government and the financial system. What are the consequences of governments' reliance on the financial sector for finance? What are the sources of finance for the public sector borrowing requirement? Are these sources coming only from the financial sector? Only from inflation? Or are they coming from other kinds of mixtures? This is the sort of thing we were talking about in connection with Joshua Greene's paper that has to be developed in more detail. What sort of seigniorage is being extracted from the financial sector?

We must also put the question the other way: What are the consequences for the financial sector of reliance on government to protect it? The literature we have on industrial economies suggests that the regulations often end up working in the interest of the regulated rather than the other way around. One often suspects that is what is happening in many of the African economies as well.

One has to be careful here because the financial sector may be at the heart of the patronage system. One cannot simply abandon that source of patronage without finding some form of substitute. Or, more accurately, one cannot simply recommend its abandonment without finding an appropriate substitute, because without such a substitute, we know very well it is not going to be abandoned. The question thus arises, How do we manage change?

Finally, in connection with government interactions with the financial system, we should also recognize that governments will remain major

decision makers and players in the economies, particularly the smaller economies, that government decision making on investments and the mobilization of resources will continue to be an important part of the governmental process. We cannot lose sight of that fact. Further, we cannot lose sight of the fact that how governments make those choices and the criteria that governments use in making those choices will be of critical importance to the overall effectiveness of the economy.

A fifth area in connection with the nature and consequences of existing systems is the question of inflation. We need to understand how and why inflation emerges. We had a good start in the discussion of Joshua Greene's paper.

More than that, we need to understand the consequences of inflation. There is, for example, the careful work of Stanley Fisher showing that inflation in the United States at roughly 10 percent costs several percentage points of gross domestic product. What we need in my view is a comparable analysis for a few developing countries that exhibit some of the common distortions and that have been prone to inflation. If indeed the costs are anywhere near that magnitude in the developing country context, that is something we need to look at quite seriously.

Sixth in this area is the question of capital flight. This came up as our discussions started to get into some of the nitty-gritty of the way the financial systems are actually working, and some of these arrangements permit and do not permit smooth capital transactions.

We all know that capital flight will take place when the incentives are big enough. There are questions of how large it is or is going to be, whether or not it is going to have adverse effects on the rest of the economy, and how rapidly it is changing. What are the lessons from the experience of capital flight?

A third major area to be looked at is the optimal evolution of the financial sector. We know that as countries develop, their formal financial systems become deeper and more sophisticated; and we know that this facilitates the process of further development. I think there is a genuine question as to how that evolution should occur in the African context.

Many African countries have suffered repeatedly from alien systems of government and economic organization rather than relying on the evolution of systems that built upon traditional systems and values. Consequently Africans have repeatedly found themselves trying to cope with both political and economic systems that simply do not fit.

The financial system is no exception to this. For example, when governments force an extension of nonbank financial institutions into the countryside and dispense credit through those nonbank financial institutions and then the farmers find themselves unable to repay, there is a clash of cultures that we had very vividly described to us by Parker Shipton. The clash of cultures is not particularly surprising, but there are lessons that we

have to draw in understanding the appropriate evolution of the financial sector in the African context.

No one would argue that a return to the very narrow kin-based, village-based financial system would be appropriate as an overall solution, because the limitations of that system are serious. One wants to avoid the trap of assuming that what was appropriate in a traditional society is necessarily appropriate in the modern society. In trying to understand how the systems should evolve, we do need to know what are the successful cases that build on traditional mechanisms. Is the experience of some of these cases that build on traditional systems generalizable? Are there some experiments that indeed should be tried? If so, what is the nature of those experiments?

The principal message that I got from Jo Ann Paulson's masterful survey is that what we need to do is to look at some of these fundamentals and build on the fundamentals, rather than try to be fancy and replicate the complex systems that we find in industrial countries.

Similarly, Carlos Cuevas emphasized the need for much more research on the fundamentals, such as the nature of loan contracts in informal markets, research on the nature of market structures, on behavior and performance of traditional savings and credit groups, and on behavior and performance of quasi-formal institutions such as credit unions and the popular banks. It is important to remember that if we are really going to understand appropriate evolution of the financial sector, we must understand what those fundamentals are and how they link with the value systems in the context of any particular country.

The fourth major area relates to macroeconomic and monetary stability on the one hand and financial sector development on the other. It is clear that financial liberalization alone can be destabilizing. Yet, at the same time, many attempts at achieving real economic reform have been stalled by the lack of a smoothly functioning financial system. Thus we need to understand the delicate balance between the real economy and the financial sector. There are several dimensions to this.

First of all is the question of the sequencing of real and financial changes. The 1989 *World Development Report* argues, largely on the basis of the experience of Latin American southern cone countries, that financial liberalization before other reforms is likely to result in destabilizing capital flows, high interest rates, and corporate distress. Is this always the case? Is this the case in the African experience?

Within the financial sector itself there are many sequencing questions. One, for example, is the question of liberalization and competition. If we simply liberalize first and wait for competition to emerge later, all we are likely to do in the short run is simply to increase the oligopoly profits of largely expatriate-owned banks. Is that something that is going to be acceptable in the local political balance?

The second issue in this relationship between macrostability and financial sector development is, simply, the real effects of financial reform. What does getting interest rates right really do for the economy in comparison with arbitrary allocation of credit? Our modeling can tell us a lot here. It can tell us that getting interest rates right can provide some really quite substantial effects. Look at the rates of return on savings, for example. Assume that 10 percent of income in the economy is being saved and invested at zero real rate of return instead of, say, 10 percent real rate of return. Very quickly one can come to the conclusion that one would be better off not saving anything. It takes little arithmetic to show that kind of result.

If that is the kind of result that has been occurring, it is a very powerful explanation for many of the problems that have been faced in the African economies in the past three decades. Yet is that the real source? We really need to understand that linkage in much more detail.

Third in this question of the relationship between macroeconomic stability and financial sector development is the relationship between real disturbances and the financial system. Are some financial systems better at accommodating real disturbances than others? Or is there simply a neutrality there, it making little difference what kind of financial system is in place?

For example, what can we learn from the difficulty the franc zone appears to have had in insulating itself from the effects of commodity booms, when other financial systems seem to have performed better in that respect? Or is it simply the fact that a commodity boom creates real incomes and that their recipients will always want to spend them as fast as they can?

Fourth in this area is the interaction between the formal and informal sectors. What is the impact of formal sector policy changes on the informal and curb markets? Is there simply switching between the two? What are the implications of informal and curb markets for stabilization policies?

In light of the existence of informal networks throughout the country, what are the costs of extending branch networks throughout the country? Are such extensions simply substituting the formal sector again for the informal sector?

The same sort of question applies in regard to the nonbank financial institutions such as insurance, pension, and social security: Are we substituting, or is there a complementary relationship here between the informal and the formal sectors?

Putting this together, then, is there some sort of idealized strategy and sequence of reform for both the real and the financial sectors? What should guide governments' policies in this reform process?

The fifth major area is something that for lack of a better word I have

labeled reform mongering. When it comes to promoting reform, several points must be remembered.

First of all, getting back to what I started with, what is it that really generates long-term growth in the economy, and how does the financial sector contribute to that? We have to understand that question before we start to make claims as to what the financial sector is going to contribute to the process.

Second is the question of short-term pain for long-term gain, as it is often put. Usually that is as far as the rhetoric goes. It is often assumed that just because there is the pain there must be some long-term gain. I think we have to be very careful not to fall into a trap. We have to ask the question, Is it really worth it? Does the future income really improve enough to justify the cost of disruption? What are the distributional consequences of many of these changes that we advocate? Are there alternatives that could be less disruptive? Especially for the very poor?

Third in the question of reform mongering, we have to understand a little bit better how much of reform is really getting the prices right relative to how much is due to careful management of the reform itself. All too often we accept the slogan "we must get the prices right" and then abandon the detailed reform implementation process. This can result in a situation where it turns out that "getting the prices right" is not enough: the anticipated effects have been blocked by some other obstacle.

Fourth in the reform mongering area is the question of political and bureaucratic commitment. Are governments convinced of the need for reform? Or are they simply being dragged reluctantly by conditionality terms that arise from the good ideas generated in Washington? How do differences in degree of political and bureaucratic commitment affect the outcome? Some very interesting work has been done along these lines by John Thomas and Merilee Grindle at the Harvard Institute for International Development on what happens after the decision is made in the implementation of policy reforms.

Let me conclude by suggesting some process for financial sector research. Case studies alone are not enough. We need a broad and consistent analytical framework to try to draw together understanding in a way that helps us generalize from case studies.

The example of the Bhagwati-Krueger study of foreign trade regimes and economic development is a very valuable way of approaching the synthesis of several cases in a common context. One criticism I would have of that study, however, is that it did not always involve researchers in the countries that were being studied. We do need to have much more involvement of researchers in Africa on African problems. We also need to have involvement of those who are active in individual projects so that we can better understand what is actually happening in those projects rather

than simply coming in after the fact and trying to piece together what went on. Here I am particularly struck by the medical profession. Much medical research involves active medical practitioners who are engaged in research as a part of their medical practice. Perhaps as economists we might want to do more of that kind of research.

I would suggest that coming out of this conference it might be useful, then, to have some form of process leading to further research in this important area. It might go something along the following lines:

- An inventory of issues. What issues and problems need to be considered?
- A selection of potential cases. Here I would suggest that we keep the number reasonably modest.
- The development of an analytical framework.
- The use of a small steering group of World Bank, International Monetary Fund, Agency for International Development, and perhaps a small number of academics, to establish a research program that might provide the continuity that I think is absolutely necessary for a serious research effort.
- The mobilization of funding for the program.
- The selection of researchers to carry out the task.

Discussion

Anand Chandavarkar: Thanking Professor Leith for his excellent summing up and presentation, may I make three specific suggestions as a starter for a possible research agenda.

The general area of costs of intermediation and margins in banking in the African context merits high priority.

The second project I suggest for research would address whether the financial system in the African countries involves an urban bias in the sense of an excessive transfer of rural savings into urban outlets through the branch banking systems. As commercial bankers know, some branches function as net deposit centers, and others function as net credit centers. To what extent is this phenomenon pervasive in the African countries?

Another area is the range of linkages between the formal and the informal sector, on both the lending and the borrowing sides, as suggested by the experience of Korea and India, where the informal sector is emerging through the urban curb markets as an intermediary between segments of the formal sector as a means of circumventing banking credit controls.

Joshua Greene: I would like to add a proposal for a study on entrepreneurship and its financing in African countries. This might involve some interdisciplinary, even anthropological, work, perhaps focusing on the Asian community in East Africa and the Lebanese community in West Africa.

Jerry Wolgin: One area that we have not discussed much in the conference or in the list of possible research subjects is the instruments of monetary control and the effectiveness of those instruments. It seems to me that there is quite incomplete knowledge about the different means that governments have at their disposal for affecting the money supply and monetary policy, about the differences of the means employed among countries (including how different they are from what is usually practiced in the United States), and about the degree to which the African countries should be moving toward more indirect as opposed to direct methods of controlling credit.

S. Thillairajah: Quite often during these proceedings investment opportunities and unmet credit demand have been mentioned. It is always assumed that there is an unmet demand. Is it possible or probable that the real opportunities for investments are not there—and there is no unmet demand—and we are working on wrong assumptions?

I wonder whether it is worthwhile to do some kind of studies really to find out what the investment opportunities are in any particular country or area and what this unmet demand is. How does one measure it? Or do we just go by a gut feeling that if we pumped in more money there would be better technology used and more investments made?

Philippe Callier: I would like to add some comments to the suggestion that we need to study the effects that reliance on foreign savings may have on resource mobilization in a country. I believe that this study should also take into account the other side of the coin: the effects of the flows of capital from the country to the rest of the world.

Sometimes we call these flows "capital flight," and Professor Leith suggested that one question was how fast the damages caused by capital flight are felt. I would like to suggest a more positive view. What are the benefits of capital outflows for the economy?

I can see two types of benefits for the country and for the financial sector. First, holding savings in the form of foreign assets increases portfolio diversification. Thus, as a community, the country that allows capital outflows can diversify its portfolio and to some extent reduce its risk. For example, it can somewhat stabilize its real income (and that of its financial intermediaries) in the face of external shocks if the public and the domestic financial institutions hold financial assets denominated in foreign currencies or have equity investments abroad.

The second benefit of capital flight or capital outflows is relevant when there are big distortions in the real sector of the economy, so that prices and profitability are likely to provide misleading signals to investors, increasing the risk of investing real resources in inefficient industries. The problem is that physical investment is not reversible. Real capital is lost if, for example, external trade is liberalized and protected factories or entire sectors become suddenly unprofitable. By contrast, if the country has

invested its savings abroad instead of building inefficient industries, these resources will still be available to finance real investment in profitable sectors after trade liberalization.

Donald Mathieson: I want to follow up on the two previous comments and suggest a framework in which some of these resource mobilization issues can be tackled. Early in this forum Millard Long suggested that the role of financial reform must be analyzed in the context of what sources other than domestic savings are likely to be available to finance investment. What are the prospects for private flows from abroad or official flows from abroad? If those are limited in the 1990s, what is the potential contribution from either the public sector or the private sector in terms of resource mobilization within these countries? In that context, what can financial liberalization or reform contribute?

We might then be able to use this approach, for example, to address the question of the relationship between savings and interest rates in a slightly broader context, which also integrates capital flight considerations. Thus, even if there is relatively limited interest rate elasticity of the total savings, domestic interest rate policy may make a big difference in whether the funds are placed domestically or abroad.

One other issue for research that has arisen out of our discussions is the role of the informal markets and the flexibility of financial structures. One has the distinct impression that most of the formal structures in African countries have a very limited ability to achieve a diversified portfolio of assets. Often they hold assets whose return is tied to developments in only one or two key commodities, and as a result there is no portfolio diversification.

How can we design systems that can handle that type of situation? Currently we have systems that are par value deposit systems with fixed interest rate contracts. An alternative would be a mutual fund type of arrangement where one does not guarantee a fixed nominal return, one just guarantees a share of the total portfolio return.

Joseph Goodwin: With respect to Jerry Wolgin's recommendation that direct versus indirect credit controls be studied, we have a program with the government of Zaire in which we are in the process of working with the central bank to do studies that look at exactly those questions.

For example, at the moment in Kinshasa the central bank has reserve requirements of 60 percent, which are heavily costly on the financials. As we want to move from that to more indirect credit controls, there are a lot of implications for financing bank operations, as well as coming up with financial instruments. So that is an area that we will be working in.

The other point I would like to make is pertinent to research on the relationship between the government and the financial sector. As the case of the National Milling Corporation in Tanzania has illustrated in this conference, where there is extensive government ownership of banks, the

government may use the banking system to promote hidden subsidies. I have seen the same thing in Sudan and Ghana.

When I was in Tanzania, the National Milling Corporation had a monopoly on marketing maize, which was the staple food. It had to sell the maize at fixed prices—at that time, 2.75 shillings a kilo. The cost was 4. The National Bank of Commerce provided for this with essentially unlimited credit. The same thing occurred with cotton parastatals.

To the extent that the banking system is employed for providing subsidies, it hides not only the subsidies but the real size of the fiscal deficit. Because of this, measurements of the impact of fiscal deficits on inflation can also be disguised—something that studies like that of Joshua Greene must contend with and, it is hoped, correct for.

In addition, such hidden subsidies (and deficits) send a signal to the banking system that banking is not really very serious. When 68 percent of the loans of a banking system are nonperforming and probably the majority of those are imposed by the government, how do we tell managers of the banking system that they are being held responsible for the system's performance or that this is a serious system?

In our program in Zaire, we have sat down with government officials and laid out a series of hypotheses about the direction of the banking system. In general there has been some agreement with the government that seems to make sense. But we are going to have to do analysis and proceed very slowly. Otherwise, as Dr. Leith was saying, what we come up with as solutions may be perceived by government officials as being worse than the problem right now. It seems to me that we are walking into unknown territory. That is why I would be very interested in finding out from other people what their experiences have been.

J. O. Sanusi: Most of the references being made to African countries in this forum give me an impression that in the process of research into financial sectors in Africa, the biggest economy in the continent has been ignored. This is because, I believe, people have not really focused their attention on that particular country.

I am here offering the cooperation and assistance of the Research Department of the Central Bank of Nigeria to those of you who might be interested in researching into what happens to the financial system in Nigeria. I believe there is no way one can get a true representation of the actual African situation without knowledge of what is happening in Nigeria.

It frequently happens, as it has during the course of this conference, that people draw up a scenario that they regard as a typical set for Africa until they include Nigeria. That inclusion upsets their scenario; consequently they remove Nigeria from the scenario in order to have a typical model.

[Laughter.]

During the course of his summary, Professor Leith referred to eco-

nomic institutions that do not fit. This is contrary to the impression I got from earlier discussion that although we have the traditional-informal sector and the formal-modern banking sector, these two separate institutions do not conflict but rather complement each other. So I am unconvinced by the conclusion about institutions not fitting.

In the present discussion someone suggested that an advantage of structural adjustment programs is that they increase the diversification of investment, including some reversal of capital flight when the proper reforms have been carried out. This may be overoptimistic, for in spite of a lot of structural adjustments that have been undertaken, in spite of the reforms, in spite of the pains without gains that have been undertaken, it has been difficult in most African countries to restore that confidence that could really facilitate the reversal of capital flow.

One of the issues that can be further investigated—I know some efforts have been made in the past—is this problem of restoring confidence. But what is the basic thing that makes it difficult for confidence to be generated in African economies? We know that in many of these countries there is a great deal of potential and what are really needed are the technology and the resources to exploit the potential. I feel that it will be of benefit to the world at large if these potentials can be exploited, because by so doing we increase not just the wealth of Africa but the total wealth of the world.

I also want to refer to one of the major problems financial institutions in Africa will face—something that might be looked at by researchers—and that is what I would describe as project identification and development. In certain cases there are financial resources available in the banks that cannot find viable proposals in need of financing. This is an area that is very, very important. One of the major problems for the African countries as a whole is to be able to identify bankable projects and put up packages that can be profitably financed. Otherwise, it does not matter how much resources one can mobilize locally from the people.

There is another constraint resulting from limited foreign exchange receipts. That is the ability of these countries to export to other parts of the world, to earn foreign exchange that can be used to finance foreign counterpart of the local investments, especially machinery and equipment, that would be needed from other parts of the world.

Generally, for funds to flow into these African countries, there is the matter of confidence I have already mentioned. But when we talk of the matter of confidence, I would refer to what happened here after the two world wars. Between the First and Second World wars there was a massive investment of America in Europe, and after the Second World War there were controversies as to whether this investment should continue to flow to Europe. Of course, the fear of the Russians at that time forced America to decide that even if it was not going to have a repayment of these loans, it would continue to put resources in Europe to stop the influence of the

Russians. Unfortunately, we do not now have that kind of fear in Africa to compel investors.

[Laughter.]

But countries and institutions that have contracts and have a lot of influence on what happens between Africa and the rest of the Western world should see the need for a change of attitude toward investment in the African countries.

Mohamadou Diop: I would like to suggest, if they have not already been included in the research proposal, the inclusion of the following questions. First, to what extent are the high social security contributions and perhaps fiscal policies and the availability of various private insurance services, such as life insurance policies and the retirement type of insurance, contributing to savings organizations?

Second, what are the present and foreseeable linkages between problems in the various insurance systems and those of the financial sector? In Senegal, and I would presume in other French speaking countries—as you know, social security policies were copied from the French system—the banking system relies very heavily on the savings of these institutions.

But over the years pension fund savings, for example, have been shrinking. They have been shrinking because, on the supply side, the number of enterprises and the number of workers contributing have been decreasing because of layoffs, bankruptcies, and so on. Conversely, there is an increasing number of retirees, who are beneficiaries on the demand side. In addition, fiscal evasions, which include evasions of social security contributions, have developed to such an extent that many enterprises that employ, say, 100 workers, officially declare about 15 of them, because it is on the basis of that declaration that they will be subjected to social security payments.

There is a risk of a second wave of financial problems coming from the social security institution and I would think, from the private sector's point of view, the insurance companies. Institutionally the insurance companies are probably in just as bad a shape as the banking system. These insurance companies also have been major depositors into the banking system. Financial sector research should include looking into this. If it does not and the "financial sector" is very restrictively defined, we are likely to have a second round of problems.

Alan Gelb: There are two sides to the problem of developing a research agenda on African finance: one should have interesting and relevant topics, and the topics should be researchable. One can imagine looking at all kinds of things, but the question is, How would one do it? That is one of the challenges that follows this conference.

At the World Bank we have, of course, been focusing on African experience. One of the questions that we have been puzzling over at some length is, To what extent is the African experience unique, and to what

extent can we learn from what has happened or what is happening elsewhere in the world? Many of the problems facing African financial systems are not very different from the kinds of problems that have faced other parts of the world. Maybe five, six, seven years ago, Latin America was seen as the big focus of financial sector work, and bankruptcy was seen as a Latin American problem. Then, lo and behold, came the Latin Americanization of parts of Yugoslavia and Poland and the Latin Americanization of certain other countries, such as the Philippines. Therefore, when considering what African countries can do about financial systems that are in serious solvency problems, we should look very carefully outside Africa to see where these problems have been diagnosed earlier.

Let me now run through what would be my checklist of researchable topics, some of which have been mentioned before. It would be very useful to know more about taxation, in a broad sense, of financial systems in Africa. What are governments using their systems for, in terms of extracting revenues? And what kinds of cross-subsidization are going on through these systems?

We have done that kind of work in a number of countries, such as Brazil, where the extraction of seigniorage from the financial system plus the cross-subsidization that is effected through the financial system amounts to about 8 percent of gross domestic product, very large and with serious consequences for the system. Who wins, who loses, what is the impact of changing regulation? We should do such exercises much more systematically across countries.

Work on the instruments of monetary control that are being used in these countries and their effectiveness is very valuable, especially in a comparative framework. The IMF Central Banking Department has a paper out in this area.

My third choice relates closely to the point that Mr. Diop just raised, and this is the question of the generation and the use of longer-term formal savings. We find ourselves in a paradoxical situation at the World Bank. We have a number of lines of credits that are supposed to supply long-term funds for development; yet, when we look at the countries, we find that some have quite reasonable internal sources of long-term funds but do not use them for long-term development, and they do not have markets to allocate them. What happens to these supplies of long-term funds? If they are not there, why aren't they there? If they are there, why are they usually earning very low returns?

This, of course, feeds into the question of the solvency condition of the insurance industry and the social security system and so on, another topic that should be looked at across countries, at least those at the higher end of the income scale.

We heard that in Kenya the stock market was moribund because of regulation. Is that true? If it is true, is it the case in other countries? Are

there regulations that effectively prevent markets from working? Certain countries have regulations, for instance, on the way in which government debt is marketed that effectively prevent the emergence of any kind of short-term financial market in the country. Those should be assembled and looked at in a comparative framework.

Similarly, it would be very worthwhile to survey the regulatory systems of a number of countries, with a view to understanding how they stack up from the prudential standpoint, and also to assess their common weaknesses and strengths.

Next, this question of institutional innovations—for example, the strengths of traditional financial institutions, what we can learn from them, and linkages—is an area where we need almost a "medical" case study approach to research, as mentioned earlier. Those actually doing the experiments need to have very close contact with people whose bent is more in studying the experiments. This is not always easy to do: the operators want to operate, and the researchers want to research. The operators do not want research, sometimes because it slows down the operation. They do not want a base line survey that takes two years, even if this provides something to compare with later. This is a very common problem. If we can find ways around it, I think we can get a much richer menu of experience to do some actual research on. That is where linkages can come in.

There are people with skills and time. There are institutions with money. And then there are other institutions with projects. Somehow they need to be brought together in a coherent way.

My seventh topic would be the legal underpinnings of financial systems in developing countries. We have a number of countries where for legal reasons we could not really expect formal financial systems to function very well. Perhaps some surveying across countries of the legal underpinnings of financial contracts might be of some use.

Finally, I want to raise a question. What is the audience for all this research? In many cases the problems of financial systems are not just that we do not know enough but that they are not well adapted to a market environment. There is a need for training, and there is a need for considerable investment in human skills.

I do not know whether this conference should address training and the implementation of training programs. But are there common areas of knowledge, where something could usefully be done in distilling experience, building curricula, and centralizing training activities, so that it will be possible to have a really *substantial* effort in upgrading skills? Even skills that are regarded here as very basic may be very important in many banking systems.

Nancy Benjamin: I would be interested in hearing more from some of our representatives from the African countries. I have questions about the

Central Bank of Nigeria, how they see themselves participating in research projects. Can they imagine the people who would be involved? Can they imagine conducting studies to help provide data? Do they have personnel available? Would they be able to do it while staying in their regular jobs, or would they have to be transferred out for a while? What kind of resources do they have available?

Ulrike Wilson: To follow up on this, I would say, on the basis of experience gained during IMF operational work in African countries, that there is a lot of expertise to be found in African countries, and this should not be underestimated. There is in particular a lot of expertise in the central banks.

Mention was made earlier of the need for a steering committee that would be composed of the IMF, the World Bank, and academia; we would need to add to that representatives of African central banks, African financial institutions. I would say that once ideas for research emanate from such a comprehensive steering committee, we could then involve African central banks, in particular, and get them to participate in such studies.

As an example, I would point to the work that has recently been done by staff of the IMF and of the Central Bank of the West African States (BCEAO) on instruments of monetary control and their application in the BCEAO monetary union. That was an example of in-depth cooperation between IMF and BCEAO research staff. This can be extended to other countries as well.

C. S. Kimei: I would certainly join hands with the previous speaker, because I think that African central banks and the other financial institutions in Africa are interested in getting research findings that are practical and suitable to the financial environment in their countries.

I am, therefore, convinced that the Bank of Tanzania would appreciate very much having joint studies with foreign experts. Indeed, the Tanzanian Banking Commission has adopted this approach of conducting the relevant studies jointly between external and local experts. In fact, the idea of conducting joint studies with African researchers will, in the long run, strengthen the African research capability in those fields.

Participation of local personnel in the earmarked studies will facilitate accessibility to statistical and other factual information available in the central banks and in other financial institutions. Moreover, applicability of traditional theory to the African environment might be more easily modeled by a local expert.

It might be very difficult, however, for a foreigner to solicit information from remote areas, on account of language barriers and other factors. The people might be afraid to release information to strangers. There is no doubt, therefore, that to get information, especially in respect of the less organized sectors or groups, one must get support from the central bank and other local authorities, and this support may be realized faster when

local experts are involved. I, therefore, strongly feel that Africans will appreciate having their local researchers participating jointly with foreigners in research topics relevant to their countries.

Sandra Frydman: I would like to pick up on Alan Gelb's very comprehensive menu for research and add to that the savings side, that we should provide some emphasis on that. So many of our financial sector programs focus on bank restructuring, prudential regulations, interest rates, capital adequacy, and so forth. I was very interested in Monsieur Diop's discussion of some of the savings instruments that his bank has been trying to develop in response to and discovery of market niches.

In order to make some of our research operational, we should be looking at doing a survey of what the appropriate financial savings instruments are, how they should be targeted. Are we talking about informal, or traditional, financial sectors? How liquid should these financial instruments be? Are we talking short term, medium? How comfortable are these? Perhaps we may want to transfer the tontine mechanisms into more of a term structure. Is that possible within the framework of many countries' financial systems? We want to focus on that and on the informal or the nonregulated. How should we market these? We are looking at banks in which many people in many countries do not have confidence. Do we want to market these through the up-and-coming savings and loan institutions? I would like to see these questions about savings instruments added to our agenda for financial research.

Michael Sarris: On this relationship between the IMF, the World Bank, AID, and the African countries, in addition to central banks we have to think of universities. They are important sources of people who are academically proficient and are also close to the operational scene.

In Nigeria, Tanzania, and elsewhere there are good universities—and we are already using them to some extent. There is also the Center for Monetary Studies in Dakar, which is supposed to be doing a number of studies in financial areas. We have to see how we can help in training and technical assistance and further cooperation.

The list of research topics that everybody has mentioned today is quite comprehensive. I would like to spell out some ideas. First, we must be careful not to be discovering the wheel too many times over. In Africa in many cases the real problems have to do with correcting the macroframework.

The difficulties of the financial sector come from that and also the political realities. There is not very much to research if you know that the financial institution does what the minister of finance tells it to do. If somebody picks up the phone and says, "You have to make that loan," and then it goes bust, or if there is a public enterprise that goes belly up, the institution gets into difficulty. No research is going to help us on that. We have to be very realistic about that.

What we are talking about is backed by the assumption that we are

correcting the macroframework and that we will have a better political environment. Let us assume that. Then we ask, How do we manage the transition? The long-standing difficulties with the macropolitical framework have created problems for the financial sector that need to be corrected—this becomes the issue. How does one manage that? Some of these issues were discussed earlier. Institutions have not had a chance to develop instruments because they are always being told that agriculture gets *X* and industry gets *Y* and they get it at different interest rates. Everybody knew that none of this money went to agriculture, because if you have cheap credit, anything you do, you call agriculture.

In Zaire, for example, concessionary agricultural credit financed everything. Everybody showed up and said, "That's what I'm doing." We have to be clear about that, and we have also to be clear that few problems are unique to Africa; the moment those of us who work in Africa begin saying otherwise, that is a sign that we have been working on Africa too long. We see that all the time. That is why there is value in moving people around, because they realize that that is not so, that economic agents react to the same signals in the same way everywhere.

It is interesting that the problem of Nigeria was brought up. Nigeria is bigger than any of the African groups that are now supposed to get together to get results from economic integration. Here we have a great example of the kind of country that is as big as the rest of the ECOWAS (the Economic Community of West African States). Here we have one experiment, the big country, the market, the critical mass, and nothing very much came of it.

I was also very interested that Mr. Sanusi mentioned Europe after the war. It happens to be a fact that Nigeria, as a result of the oil boom, received in extra dollars an amount equal to the Marshall Plan. And we can just compare the results.

So it is not a question of money. If there is an important lesson, it is that the foreign exchange shortage that is supposed to be constraining economic activity is not the binding constraint in many African cases. I think Nigeria has done well in using domestic resources when it did not have access to foreign exchange. But that was just as an aside.

Let me complete this intervention by saying that we are ourselves trying to put a small agenda together, and we are trying to get the African Development Bank and the European Community to join forces with us, and, of course, we are cooperating here with AID and the IMF But in terms of funding, we are trying to get the EC and the African Development Bank on board to study some of the specific transitional issues that Alan Gelb has mentioned.

How do we go from sectoral credit allocations to systems where we have a more neutral system of monetary controls? How do we deal with a case where countries receive big loans for small-scale enterprises, which are supposed to be intermediated at rates well below the rate of inflation?

What do we do in a case like that? Do we say, "I stay at home until the country puts its stabilization house in order"? We cannot talk about nominal interest rates of 70, 80, 100 percent if we want to make them positive. We clearly have to get the rate of inflation under control before we can intermediate financial resources.

The other side of the equation is, If we have an adjustment going on, as it is going on in Nigeria, without investment, then how are we going to move resources from where they are to where they should be? There is a real dilemma here. We must have investment, but we cannot have it in an environment where it will go to the wrong places. That is a very important issue for an institution whose bread and butter is making loans.

We have to find ways in which to transfer resources efficiently. So we really have to try to get some answers to these questions. I endorse the idea of coming up with some ideas that all the participants in this conference could keep working together to define further, then seeing how they can be apportioned among different people, and perhaps returning to them some time later to see what has been done.

Lawrence White: I want to pick up on something Michael Sarris said and tie it to something that Alan Gelb said. Michael Sarris said that no research will help us if governments are simply using the financial system to accomplish transfers of subsidies.

In a sense that is right. Research about what a proper set of institutions and regulations would look like is not going to be of much interest to governments that are using financial systems as wealth transfer devices. But if that is in fact the way they are using financial systems, then another line of research becomes very important. We have to study seriously exactly what governments are doing and why (for whom) they are doing it. Alan Gelb touched on this in his first point, when he said that we need to study the magnitude of the wealth transfers taking place through financial regulation.

I was a little puzzled in this regard by Anthony Saunders's paper. When he was discussing financial innovations, he mentioned just in passing that in the African context most of the innovations have come from government. He was using the same analytical framework to try to explain government interventions as would be used to explain market-oriented innovations.

I do not think that is the right way to proceed. We need to take an unsentimental look at what is actually motivating governments in the set of financial interventions that they make. We all recognize that sometimes their incentives may be something other than maximizing GDP or the welfare of the representative individual. Conditionality programs are premised on that understanding, aren't they?

We need to take a serious look at exactly what is at stake in financial regulation and to what extent it is being used as a tool for gathering seigniorage and distributing subsidies. If wealth transfers are the object of a

government's financial policies, what does that imply about the possibilities for reform?

Richard Breen: Perhaps this is just a footnote, but it seems that all the recommendations of the external agencies to the developing countries concerning liberalization and neutral financial sectors and so forth have been compromised a little bit by the practice of preparing these lines of credit to the central bank for specific kinds of interventions, certain kinds of cattle, certain kinds of agriculture, certain kinds of industry. It really amounts, in some cases, to central banks as a series of spigots or lines of credits, which are supposed to go through the banking system. If that is not directed credit, I do not know what is. I could not identify it. What are the consequences for the financial system from all of this paraphernalia being brought by the external assistance people?

Alan Gelb: This is a very relevant question and something that has caused a lot of soul searching in the World Bank itself. How can we be in favor of liberalizing financial markets when we are ourselves a directed credit institution? If the World Bank did not exist to fund selected credit lines, would we need to invent something else? Is there severe market failure? Recognition of the problems that development finance institutions have run into, which have been progressively growing over the 1980s, has led to much questioning of this model of financing development through selective credit lines, particularly in financial systems that are thought to be highly distorted in various ways.

There has just been a major review exercise within the World Bank of our own practices in this respect. In very broad terms, without going into details, it argues for a shift in emphasis away from thinking of these credit lines as being project finance and focusing much more on the reforms of the financial institutions through which credit lines flow. It would then be harder to send, say, the eighth line of agricultural credit through a bank that has a 30 percent recovery rate on its loans.

But the question is still a very difficult one, because, particularly when we have countries that are very unstable and when financial markets are really not well developed, would one consider the market an adequate allocator of resources? I do not see a consensus on that basic question within the institution. Some people favor the market as the allocator, because there is nothing better. Others argue that in some cases the distortions are so obvious and gross that the market option is not possible, and then the question is what to do. But you have touched on a very tender issue.

Richard Breen: I do not suggest that they go to the World Bank. In Latin America is the International Development Bank (IDB) and the NAIB, and in certain countries one can simply walk into the central bank. There is a whole list of these things.

Joshua Greene: I would like to pick up on the suggestion about

connections between the financial sector and other sectors of the economy and also on the point of the deputy governor from Nigeria about the importance of business confidence in an economy. We have to do more research into examining the various factors across sectors that lead to the development or absence of business confidence.

It might be useful at some point to have a kind of interdisciplinary team that looks at not only financial sector issues but also issues in investment codes, tax regulation, and other things that would be very important for stimulating investment in countries.

It might also be interesting to identify a few places, not necessarily only in Africa, that seem to be successful at stimulating investment and see if particular factors for this success can be identified. This knowledge could then be transferred to other countries as a basis for stimulating investment, both locally financed and provided by direct investment from overseas.

Patrick Honohan: Regarding the potential for building on these informal rotating savings and credit schemes and the tontines and so forth, Donald Mathieson's earlier question is pertinent: Are we going to run into prudential problems if we think of expanding these into a more substantial part of the financial system? I think there is this risk. I want to remind you of the experience in the Philippines in the late 1970s and early 1980s, when a money market developed outside the banking system, which was very substantially supported on both the borrowing and the lending side by the Chinese business community.

This money market was really quite ahead of financial development in other countries. One of the reasons it emerged and grew so rapidly, I am told, is that there was a substantial degree of confidence based on ethnicity. The Chinese businessmen said: "We, as Chinese, trust each other. We know the families. They've been in the Philippines for many years. We don't really need to be very particular about documentation or collateral or so on. We know our people won't default."

But there was a massive default. One of the biggest borrowers, if not the biggest borrower, in the market just left the country, leaving very substantial debts behind, which more or less brought down the entire market. There had to be heavy central bank interventions. Some of the bigger banks had to purchase, with assistance from the central bank, the finance houses participating in the market.

It suggested to me that there is a kind of vulnerability, that once one gets too big, the stakes become too high, the lines of communication become too long. This is almost inevitable in Africa if the same kinds of links are pressed beyond what they have been accustomed to.

We know the tontines have gotten very big in Cameroon, where their development seems to be much more advanced than in other countries in Africa. I am doubtful whether it can go much further in Cameroon. That may represent something close to the limit. If so, then there are going to be

quite serious limitations to the potential of this kind of mutual trust kind of financial system in doing the kind of risk pooling and the geographical transmission of funds that we expect from a modern developed financial system.

The other point I want to make is something completely different, bearing on Anthony Saunders's paper. Although I thought it was really imaginative and a very interesting way of analyzing the developments that have taken place in financial innovation, I want to strike a cautionary note. If we confine ourselves to that perspective, we are locking ourselves into a straitjacket where there is only one direction of policy that we can adopt. We can say, "Oops, there's a government intervention. We didn't even notice it. Let's eliminate it." That is probably the priority in Africa and in most countries. There may be scope, however, for some positive government action (although maybe it is in a sense negative government action) in building up the deep infrastructure for markets that do not exist and cannot exist because of the failure of contract enforcement.

Why are contracts not enforced? For various reasons, including the fact that powerful people have access to high authority, which can overturn courts or prevent contracts from being enforced. So maybe it is not an example of government intervention as much as what might naturally emerge as a contract system that would be enforced by the law in a system where government was not so powerful.

But the government probably does have a role at this stage, in working hard to build up that infrastructure that has been a common basis in the Western European societies and the United States and has allowed financial innovations to take place. It has been the common basis, so we do not even notice it. It is not a common basis in postcolonial Africa, I think partly because some of these structures are seen as toys that came from Europe and can be dispensed with or are simply there to be exploited.

S. Thillairajah: On the last point about positive intervention, I do not suppose when a government decides to intervene, any government would admit that it is doing something in the negative mode. I find government interventions, which I think should clearly be temporary, are not. They become eternal.

Like the problems of cost, intervention too snowballs. So this is where we have to be careful to let market signals work and desist from intervention, even though bona fide most of the time.

Jane Siefert: One of the issues that has not been brought up here is that many times by the time the donors are involved, there is a crisis situation. There is economic gridlock, where liquidity has absolutely come to a standstill in a banking system. The doors have been closed down. There is no stock market. Depositors have not been repaid, and the central bank does not know how to set up its operational procedures.

It is obviously useful to do research in advance, but I do not know how

one predicts these things or when one says what is going to happen. Maybe those of you who do more research than I do can tell us that. But I think that the biggest issue is that banks and financial systems are based on two things, confidence and confidentiality.

Unless the confidence exists on all sides, a system cannot exist. Not only do the depositors have to believe they are going to be repaid, but investors have to believe that five-year money is good money because the economy will still be around in five years and the currency will still be substantially worth then what it is now. Borrowers have to believe in the system in the sense that if they do not repay, they will be sanctioned.

Often the only people who believe in the system are the borrowers, and they believe in it because they believe it is going to fail and they will not have to repay. All of that is very germane, and it has to be the basis of any research that is done.

From a donor's standpoint the biggest problem is one that was brought up in the summary. That is, at what point do we intervene, and at what point is conditionality being imposed upon a government or an economy without its political will? In other words, when is it just another bailout, and when is it really reform?

I do not know if that is a topic for research. As was pointed out by Alan Gelb, we can bring up all the topics we want to, but if we cannot research them, it is not really worthwhile. But I do not see how we decide how to put hundreds of millions of dollars into an economy if we do not know the answer to that question. And believe me, it is very complicated from where I sit.

Jo Ann Paulson: I am not sure where the research agenda, promises of funding, and the steering committee ideas discussed in this conference are going to lead. As a researcher interested in African financial markets, I have no data and very little access to institutional information. I can glean a few paragraphs about financial sectors from the World Bank and IMF country reports, assuming that I can get someone to smuggle those out to me. The proceedings of this conference are going to come out with a shopping list of research topics. The research agenda will be driven by funding from donors, and the donors usually want research to support pending policy decisions. But it will be a year or two before the results of this conference can be turned into research proposals for funding. I think we should spend a few minutes talking about ways to get people in academic institutions involved in research on Africa. Otherwise we are criticized for only doing historical research.

There has been a "failure of analysis" on Africa from the American academic community. We have not played a role in monitoring the donors. We need to talk about ways to improve communication links. Maybe, instead of talking about many possible issues, we should concentrate research on one country. That would lower the start-up costs for an

individual researcher, but I do not think many African countries would want to volunteer for this exercise.

Alan Gelb: My sense, from being an academic and then coming to the World Bank, is that it is generally true that academics are a couple of years behind the times in information. They cannot help it. That is a natural feature.

Since I know that you have worked on Asia a great deal, what, specifically, is the nature of the problem? Is it just the general problem, that academics are a couple of years behind, or are there some very specific issues in relationship to study on Africa that are problematical? Doesn't what you said apply to other countries as well? If not, why not?

Jo Ann Paulson: I will start the list on the difficulties of doing research in Africa. First, the data are more readily available and reliable for some Asian countries. One spends more time obtaining and verifying data to do a study on Africa. Frequently the central bank bulletins do not have complete or usable data on the financial system. In some countries the data problems are really quite severe. If the data are available, they are unreliable.

Second, there are many rationing mechanisms for credit allocation in most African economies, and we have to have specific institutional knowledge. A data set on prices and quantities does not provide much insight. It is harder to start a research program on an African economy because we need so much institutional knowledge.

There is more background information readily available on many Asian economies. One can find books and studies on the performance of the systems during the 1960s and 1970s. There is little background information available on many African economies. Those are a few points to start the list of difficulties of research in Africa.

Nancy Benjamin: I found in working on Africa that it seemed to be particularly important to be connected when one went into a country, that coming in under the rubric of the World Bank or some other organization provides an introduction, which means that one needs some kind of project from an official organization. For such a project to occur, a researcher may simply do something that pleases what is already on the agenda of that organization, and they call him and put in a request: "We have this project on the table, and we need someone to fill in this slot." When that does not happen, the researcher really needs to create his own project.

I have spent a fair amount of time knocking on doors at the World Bank to generate a project in an area where I thought research was important. But I had to create the project. It is not always easy, and it is time consuming. If the people in the organizations are very pressed for time, it is hard for them to think of including research in their agenda because they have so many other pressing issues.

The other problem I found—just the nitty-gritty limitations—is a reluctance, not on the part of AID but on the part of the World Bank, to send

money to a university to help it pay for graduate students. I found the World Bank tends to want you to come to them, or they will pay you, but they will not pay your graduate students. That is failing to utilize a great source of inexpensive labor for doing time-consuming data work that you would be overpaid for doing.

Anand Chandavarkar: To pursue further the interesting analogy of the medical practitioners, may I bring up a subject that appertains to financial pathology as against financial physiology? I will mention as a former central banker one important area of research for which central banks are ideally situated but on which they have done nothing. This is the very important question of why, when, and how some banking assets become nonperforming assets and an economic analysis of bad and doubtful debts. To what extent do they reflect management failures or macroeconomic factors? This is also an area where the data are waiting to be analyzed by the central banks themselves. I would use this forum to address our African central banking fraternity here, to see whether they can bridge the gap that exists in central banks between the economists and the bank examiners. Let them get together and throw light on why bad and doubtful debts emerge and the correctives for that.

Robert Porter: The last three or four comments bring up two points where I think a contribution can be made from my area of expertise, in bank supervision.

The first is that every developing country in which I have been involved in bank supervision has reinforced my development of a very deep skepticism in certain areas, not all areas, regarding the accuracy of data. Enhancing the quality of financial data is something from which any country that embraces the supervisory process can benefit.

I saw this in some countries in the north of Africa, but primarily in the situation in Botswana. In my first year there we finally dug into looking at how some returns were being prepared and going to rural branches and finding the rather junior and quite uneducated clerks filling them out. We came to the conclusion in one case that we would be better to abandon the return rather than continue it, simply because of the lack of clarity in what should be filled in and the inconsistency among returns when there was a rural branch network.

These particular kinds of examples have always led me to feel that through central banks and supervisory authorities, one of the greatest contributions of supervisors can be checking these data, getting right down to the very junior clerk who is actually adding up the numbers and determining whether he has sufficient understanding for doing it and funneling it up to superiors. The need for clarity of instructions cannot be overemphasized, because, unfortunately, what I have found is that the further along those data get, the more the economists and analysts and policy makers feel they are carved in stone.

Those of us who are visiting the branches in the rural areas and who see

how returns are actually filled out feel quite a bit less confident, to say the least. So I think that one key area where supervisors can contribute is on this nitty-gritty collection of data and whether or not it is clear to the institutions that are submitting it exactly how to do it. There is a tremendous amount of work that can be done in that, and eventually getting more reliable data would be a major project.

The second point, following up on Mr. Chandavarkar's comment about the economic analysis of bad and doubtful debts, why they emerge and the dialogue on it, I thought his point was very well taken. Again, bank supervisors are at the front line of this. This is a large part of our business. We are supposed to be digging out where these bad debts are. In addition, once we dig it out, we generally write what we call a loan write-up, a bit of a historical commentary of how they came about. A primary means of doing that is to identify problems within the bank and make sure that these are adequately provided for in an accounting sense. But at the same time we are going through the process, in looking at policies and determining what has been the track record in a historical sense, and this has multiple uses.

I would endorse any suggestion that those people, such as myself, who have been on the front line and digging into individual loans and finding out where they have gone wrong, can make a contribution to the policy makers if we see a general pattern. Because supervisors can be so close to the source of the problems, we have a contribution to make both for the accuracy of the data being submitted and also for explaining some of the historical reasons why some of the loan problems have occurred. So I just wanted to indicate where the bank supervisory process can contribute.

Mohamadou Diop: I would like to make a few comments on these statistical problems. One thing I found very impressive in the Ghana project is that there is, as part of the project, a small study to develop coherent and comparable monetary and financial performance data for the banking system.

To accomplish this several problems are faced. There is the issue of confidentiality, from the standpoint of the central banks, of government treasury authorities, and of commercial banks themselves. Because in Africa one of the problems I found out when I started working back home is the impossibility of placing myself comparatively with the competition.

First of all, a lot of banks do not have budgetary processes. There is no process by which banks compare budgetary objectives with realization. It does not exist. Most banks, particularly the indigenous banks, are in groups. We do not have budgetary processes from the group's standpoint. But usually groups have different criteria, performance criteria and so on. So one of our challenges, at least in the group, was to develop groupwide a coherent set of performance criteria, because we run into the problem that we have to use almost daily moving averages. That is one. We use quarterly, monthly, and sometimes end-of-year balances. It is a methodological problem.

When it comes to the central bank, it is the same thing. The BCEAO, for example, which has a highly developed set of periodic statistics, has two departments issuing statistics dealing with the same figures, the research department and the credit department. They look at it from very different standpoints. One looks at it from an economic, purely statistical standpoint. The other looks at it from a purely accounting and credit standpoint. When we try to merge the two, we get lost. The situation gets worse in getting statistics for the budget. The government comes out with its own budget. Senegal, for example, has a very complex statistical bureaucracy, which we inherited from the colonial administration.

I myself at one point, when we were doing studies with the old group, trying just to find coherence between these various sets of data, found it to be impossible. So I would suggest that notwithstanding the particular needs of academics, which are different from the needs of practitioners, there is a big problem here because it is very difficult to make performance comparisons.

Joshua Greene: Another issue that has developed with regard to American economists is that, for a number of reasons, the rewards in the economic profession have not gone toward studying Africa. It is unfortunate, but the way the American economy and politics are oriented, Africa does not have as high a place as some other regions.

Some of our big institutions could help to change this. Bringing in consultants in certain ways, providing research contracts, and sponsoring studies at universities, if done on a sufficient scale, could make a difference. There is no reason why people working on Africa have to see themselves as second-class citizens in the American economics profession.

Even my own institution is starting to take a more focused look at undertaking research on Africa. Unfortunately, it is rather new. Another part of the problem is that some donor institutions do not have the slack needed to accommodate research as part of their programs. Perhaps there needs to be some reallocation of resources so that their staffs have the time needed to supervise research, organize research agendas, and so on.

Overall, however, there are things we can do to help push the economics profession, so that more people will study Africa and that the intelligence now devoted to other regions is allocated a little more fairly.

Jo Ann Paulson: American academics are in demand to do consulting on Africa now. We get more phone calls than we can handle. Most American universities, however, do not want to be bases for consultants. The universities are trying to build long-term research programs and support graduate students. While there is more interest in Africa now, there is still a mismatch between the type of work done in the universities and the way work on Africa is funded. Universities are interested in developing "centers of expertise," but most resources are going for short-term consultants, not long-term research programs.

Stephen O'Connell: I am quite hopeful about the prospects for more academics getting involved in Africa, simply because the main institutions that draw academics are throwing so much money in that direction. I myself, with limited experience in Africa, get more calls than I can positively respond to. I end up suggesting names of people who have never looked at Africa before but who may become interested. So I am very hopeful about getting more academics involved.

I have two suggestions. First, with respect to financial sector research and policy advice, we need to think more about trying to recruit consultants from business schools and finance department faculties. Economists in U.S. economics departments typically do not know much about banking. Moreover, the kind of consulting that is required for banking sector restructuring is standard fare for business school faculty and much less so for economics faculty, whose interests are often more theoretical.

Second, it is important that we make an effort to attract more African graduate students to American universities. Rockefeller used to have a program that funded graduate study for African students. When I was in East Africa recently, I encountered a number of excellent economists who had gone through the program. They had not returned to Africa, however, after completing their graduate work; perhaps that had something to do with the termination of the program. But funding this kind of program should be a very high priority, both for providing a critical mass of U.S. researchers interested in Africa and for building intellectual capacity for economic policy making in African countries.

Michael Sarris: I want to make a quick point on the willingness of African governments to share information and data. That is sometimes an issue. For example, now in the context of a project that we are involved in, we have put together a large volume of statistical information. It is likely to be very useful to a lot of people, but because it follows something we published that showed adjustment to be working in Africa—causing a lot of controversy—we are now spending a lot of time trying to convince others that we should publish this new product.

Jane Siefert: I would second the motion that when we do research we should use financial economists or whoever is comfortable with finance. As a banker, I was quite astonished to hear that the financial services industry is not included when many academic economists refer to the "real" economy. I would not think that such a division of the world would be constructive in the way research is done.

The financial sector is best seen as part of the whole and not something that is different, far away and mysterious, which is something that rightly or wrongly I picked up in some of the comments as I was listening to them. I believe that it was in Professor Leith's summary that a more useful conception was provided, viewing finance as the oil for the rest of the economy.

411

14 Lawrence H. White

Separating Bank and State in Africa

The McKinnon-Shaw school (McKinnon 1973, Shaw 1973, Fry 1988) has long argued that the financial sector plays an important role in economic growth and development and that the financial sector best promotes growth and development when least "repressed" or restricted. The World Bank (1989b), or at least its research staff, appears to have taken this lesson to heart. The evidence from sub-Saharan Africa, where financial repression has gone hand in hand with economic stagnation, strongly corroborates the general argument for financial liberalization. State ownership of banks and restriction of private banks have strongly inhibited economic progress.

Keith Marsden and Thérèse Bélot (1987: 21–32) have cataloged six ways in which African states have inhibited growth and development by restricting the private sector. Their list can serve as a summary of the problems identified in the foregoing chapters.

1. *Financial repression* (typically consisting of interest rate controls and credit allocation directives) reduces intermediation. Often constrained to negative real rates of interest on deposits, formal banks cannot attract much in savings. What they do attract they cannot lend to the most productive enterprises. Directed credits go preferentially to state-owned enterprises (SOEs) or to individuals or groups with political influence or to the state itself (see Fry 1988: 398–418). Development financial institutions

(DFIs) and specialized state investment banks have been a party to, rather than a remedy for, the deliberate misallocation of funds. Unfavored borrowers, denied access to formal bank loans by the contrived shortage and official rationing of loanable funds, face higher interest rates in informal markets because of the risks inherent in illegal lending. Interest rate ceilings thus make credit more expensive to all but a favored few borrowers. Formal commercial banks, forced to lend to uncredit-worthy states, SOEs, and state-connected individuals, have suffered extensive loan losses. In Benin this problem has been particularly acute (World Bank 1989b: 170).

2. *Policies with a bias against equity* inhibit mobilization of equity capital for private enterprises. Such policies include direct control of stock issues, as by Kenya's official Capital Issues Committee; tax policies that treat equity more severely than debt; and artificial reductions of the risks of debt financing through bailouts of favored insolvent firms.

3. *Foreign exchange allocation* by the state rather than the market, like credit allocation, channels funds to SOEs and favored firms, not to the most productive users.

4. *Heavy state and SOE borrowing* crowds out productive private sector borrowing. Marsden and Bélot cite International Monetary Fund (IMF) data showing that, in fourteen of thirty-five sub-Saharan countries surveyed, the state sector consumes more than 60 percent of domestic credit. In six countries it consumes more than 75 percent.

5. *Heavy corporate and personal income taxation* squeezes retained earnings, normally an important source of capital formation, and discourages effort and enterprise. African states impose nominal personal and corporate tax rates that are unusually high by world standards. Effective rates are pushed even higher by accounting rules that disallow adjustments for (characteristically high) inflation. Some states, for example Ghana, seem even to have gone beyond the peak of the Laffer curve: high tax rates have so shrunk the tax base that revenue is less than it would be at lower rates.

6. *Foreign loans and grants are monopolized* by African states and SOEs. End-of-1984 figures, reported by Marsden and Bélot, indicate that only 0.6 percent of foreign medium- and long-term credit has gone to private enterprises. Only 0.8 percent has gone to DFIs and only 1.6 percent to mixed private-public enterprises. SOEs have received 13.9 percent. Over 75 percent has gone to finance the budget and trade deficits of central governments and central banks. Marsden and Bélot note (p. 31) that "foreign lenders have acquiesced with these priorities and perhaps even encouraged them." They suggest several reasons why. Granting loans to states and SOEs allows official donors to contribute their expertise to project selection (and to fancy that their advice makes a difference in what projects are chosen). It allows foreign governments to bias the procure-

ment of capital equipment in favor of firms back home. Bypassing the local state by choosing a project independently and lending to a private concern that undertook it would mean infringing state sovereignty. It would also mean forgoing the sovereign's guarantee of repayment backed by the power to tax. In any event the result has been that "foreign loans have reinforced the heavy public sector bias of African investments."[1]

The Problem of the Unconstrained State

It has been widely recognized in the past decade that domestic policies significantly inhibit sub-Saharan development. A notable statement of this recognition was the World Bank's issuance of what became known as the "Berg report" (Berg 1981). The stuntedness and distress of the (formal) financial sector is symptomatic of a larger problem.

Economists who understand that these policies inhibit growth and development are tempted to call them irrational. Deepak Lal (1985: 77), for instance, interjects this adjective into what is otherwise an unobjectionable conclusion:

> Most of the more serious distortions in the current workings of the price mechanism in Third World countries are due not to the inherent imperfections of the market mechanism but to irrational government interventions, of which foreign trade controls, industrial licensing, and various forms of price controls are the most important.

Elsewhere Lal (p. 53) speaks of distortions created by "irrational dirigisme." For an economist to label a course of action irrational is to suggest that it is inconsistent with the goal-seeking behavior that economics analyzes and that it therefore cannot be explained. The label unfortunately directs economists away from trying to understand why states, and African states in particular, adopt interventionist policies.

The fact of the matter is that interventionist policies are not irrational in the sense of being non-goal-oriented. The policies work against the goal of economic development, but they serve other goals that are presumably more important to state decision makers. It is the responsibility of development researchers to explain exactly how these policies suit well the objectives of those in control of the state.[2] That the policies *somehow* suit the rulers' objectives is evident from the stubbornness with which they have been pursued.

The basic obstacle to sub-Saharan financial development, and development in general, is therefore deeper than a poorly informed choice of policies by local rulers, with or without encouragement from international agencies. Better technical advice and more money from abroad will not suffice to remove it. The basic obstacle is a set of political systems that allow rulers to persist, without effective constraint, in pursuing policies favorable

to their own interests but harmful to the ruled. It is a culture of statism. Western societies suffer the same problem but generally in a lesser degree. Eastern Europe appears to have made dramatic progress, but it remains to be seen how much Eastern European states will actually shrink.

The variant of statism most familiar to economists, because it was the object of Adam Smith's criticism in his classic work in development economics, *An Inquiry into the Nature and Causes of the Wealth of Nations*, is mercantilism. Mercantilist policy aims not at promoting the ordinary citizen's welfare but at strengthening the state. Political scientist Thomas M. Callaghy (1988: 82–84) identifies the economic policies of African states as mercantilist in just this sense: "In many African countries welfare-oriented development policies are discussed at great length, but development policies that augment state and ruler power are the primary focus of implementation efforts." This is true of both nominally capitalist and nominally socialist countries.

Though the connotations of the label "mercantilist" may seem anachronistic, there are parallels between contemporary African states and the early modern European states to which the label has traditionally been applied.[5] Both are, in Callaghy's words, centralizing and "authoritarian patrimonial-bureaucratic states" in which "politics is highly personalized, and a ruling class is emerging, with the gap between the rulers and the ruled increasing." In both cases mercantilism "has been closely associated with state formation and a search for sovereignty" and "is opposed to *laissez faire* or autonomous capitalism, but not to political capitalism." Elsewhere Callaghy (1989: 100) cites Mobutu's Zaire in particular as embodying "neomercantilist economic policies designed to increase the economic and political power of the state, its ruler, and his political aristocracy."

The rulers of the postcolonial African states have typically been "free to put the squeeze on all their subjects" (Andreski 1979: 289), legally or illegally. In any society the state tends to expand "until it reaches the limits set by its capacity to squeeze other sectors" (Leeson and Nixson 1988: 72). The limits to its capacity to squeeze are determined by the ideology, resistance, and mobility of the populace (North 1979). That these limits are so unusually wide in sub-Saharan Africa may have much to do with the general absence, upon the end of colonial rule, of a critical mass of indigenous property owners with expansive and secure property rights. The historical process of "embourgeoisement," as Kornai (1990) calls it, has not advanced far enough.

The extensive state ownership of banks and other commercial enterprises in sub-Saharan Africa is an outgrowth of mercantilism compounded by the absence of indigenous private property ownership. Edward Jaycox (1988: 41), vice-president for Africa at the World Bank, notes: "There were pragmatic reasons for the expansion of the state sector [in Africa]. Politi-

cians found public enterprises to be excellent means of rewarding supporters with jobs and of forestalling urban discontent." Goran Hyden (1990: 260) likewise comments that "the tendency has been . . . to make the state as large as possible so as to accommodate competing community interests." We thus see "the practice of using the state primarily as an agency to satisfy patronage demands made in the name of given communities." The state expands so as to co-opt. The restriction of markets plays the complementary role of forestalling the emergence of an independent business community or bourgeoisie that might challenge the hegemony of the ruling elite. In a mercantilist regime the state is by design the major avenue of upward mobility. Economic life is thoroughly politicized.

Characteristic of mercantilist and other authoritarian states is the rule of men rather than of law and the corresponding abridgment of property rights. The insecurity of property rights is a major handicap to investment and capital formation (see World Bank 1989a: 9). Max Weber's characterization of the impact of unreliable law in precapitalist Europe (quoted by Callaghy 1988: 72–73) shows remarkable similarity to Africa in recent years:

> And legal systems . . . tended to be characterized by patrimonial . . . procedures, . . . and by the practices of officials seeking private gain. Reliable financial transactions, including the operation of a banking system relatively free from political interference and plundering, were particularly handicapped by these conditions.

The prevalence of corruption in sub-Saharan states and state-owned financial institutions, much remarked upon elsewhere in this volume, is symptomatic of the culture of statism. The most revealing discussion of the nature of the corruption problem is still that of Stanislav Andreski's *The African Predicament.*[1] Andreski (1979: 277–78) notes bluntly that "the use of public office for private enrichment is the normal and accepted practice in African states. . . . After only a few years in office the top politicians have amassed fortunes worth a hundred times the sum of salaries received."

The common vernacular of Africans reflects this reality. Andreski notes that the customary bribe for receiving a government contract in Nigeria is a 10 percent kickback and that this is so well known locally that anyone active in politics is called a "ten-percenter." George B. N. Ayittey (1988: 6) observes that "in East Africa the peasants have a word for the ruling elites: *wabenzi*, men of the Mercedes Benz."

The use of public office for private gain is of course historically the norm throughout the world and is by no means peculiar to contemporary African states. That is because statism has historically been the norm. The notion of a duty to *refrain* from using public office for private gain is, in Andreski's (1979: 277) words, "one of the most recent and fragile conquests of civilization." It is an outgrowth of classical liberalism's concern for properly limiting the state. Looking across societies, we naturally find that

graft varies inversely with the moral restraints a society imposes on the uses of power. Where kin solidarity is the predominant effective system of social ethics, favoritism toward the kinsmen of state officials (for example, in the awarding of state posts) occasions no moral outrage (Andreski 1979: 283–84; Amissah 1986: 42).

Constraints on state corruption are provided more or less effectively in the West by a watchful free press, an informed and outraged citizenry, and independent business and professional communities. The weakness of these constraints in sub-Saharan Africa mirrors the lack of constitutional constraint, from the same sources, on even legal state transfer activity. Illicit uses of official position grow with the size and intrusiveness of the legislated state because opportunities to charge for favors arise in proportion to the number of favors officials have to hand out. State provision of private goods, like financial services, enormously expands the field for corruption. Where the state awards monopoly rents or other favors, it is hard to imagine that the bidding process for them that we call corruption would not arise.[5] Whether rent seeking takes the form of freelance bureaucratic corruption or of officially legislated programs of wealth transfer "is not usually relevant for economic analysis of its costs" (Krueger 1990: 18). And, regardless of its form, "Rent-seeking diverts resources from productive activity and both lowers welfare and slows growth" (Gallagher 1991: 77).

By Austin Amissah's (1986: 47) count, only sixteen of the sub-Saharan states have avoided a military coup since independence.[6] Amissah argues that democratic traditions, such as public debate and truly contested elections, have never really taken root in African cultural settings in which insults of elders by nonkinsmen are intolerable and in which leaders (chieftains) have traditionally been selected by other methods (see also Hyden 1990: 258–59). Written constitutions, liberal in conception, have failed to restrain African states. George B. N. Ayittey (1987: 214) notes that only two (Botswana and Senegal) of forty-one black African states retain genuinely democratic systems. The others have discarded their independence-era constitutions for one-party systems or military regimes. Since independence only four heads of state have left office without death or overthrow (but three of those four after retaining power for twenty or more years). Since the preceding sentence was written, Kenneth Kaunda stepped aside for a successor in accepting the outcome of a presidential election in Zambia. Elsewhere in Africa there are considerable stirrings that in time may translate into limitations on the powers of national states. No continent, however, is imbued with more obstructions to such an evolution.

The boundaries of African nation-states are "an artificial creation of the foreign masters imposed upon them by force only a few decades ago" (Andreski 1979: 283). Spanning a territory encompassing rival ethnic

groups, the state has often been the instrument by which the ruling ethnic group exploits the others.[7] Independence from foreign rule has paradoxically meant the suppression of independence from domestic rule, that is, the suppression of property rights and of free markets. African governments, enabled and encouraged by foreign assistance, have tried to direct the development process from the center. In the process they have obliterated side constraints against using people and their property without consent.

So what possible use are written political constitutions in this situation? It is often said that the maintenance of a monetary constitution (such as the classical gold standard or free convertibility of the currency at an unalterable exchange rate into an international reserve currency, regarded as a restraint on the central bank) reflects rather than provides the discipline of the monetary and fiscal authorities. This argument unfortunately suggests that a constitutional rule as such is never binding. In fact simple rules can usefully lower the cost to the public of monitoring the behavior of authorities and holding them accountable.

The problem in African nations would seem to be that there is little public demand for such monitoring and accountability. No doubt the price is currently high in countries where dissent is not tolerated.[8] The suppression of political opposition can be more subtle than tossing dissidents into jail, as the following report from Robert H. Bates (1981: 117) illustrates:

> In interviewing a rich cocoa farmer in Ghana in 1978, I asked him why he did not try to organize political support among his colleagues for a rise in product prices [Ghana's state policy artificially reduced the price received by cocoa producers]. He went to his strongbox and produced a packet of documents: licenses for his vehicles, import permits for spare parts, titles to his real property and improvements, and the articles of incorporation that exempted him from a major portion of his income taxes. "If I tried to organize resistance to the government's policies on farm prices," he said while exhibiting these documents, "I would be called an enemy of the state and would lose all of these."

It is unclear whether the emergence of democracy movements throughout Africa in the early 1990s is a reaction to the abject failures of existing governments, or whether it reflects something more substantive and positive. If these new movements reflect and foster increased property ownership by an expanding population of Africans whose property rights are increasingly secure, then the prospects for the kinds of financial research and reform that are represented in this volume will be much greater as this book goes to press than they were during its first drafts of the 1989 conference.

A ray of hope with respect to increasing property ownership by a more inclusive population is the relative strength of informal markets (that is, commercial capitalism, outside the state sector). The earlier chapters in this

volume testify to the vitality of informal financial markets in sub-Saharan Africa. These markets facilitate embourgeoisement, the accumulation of wealth in the hands of a productive class independent of political power. While the state sector stagnates because of its insolvency and its "increasing ruling class closure" (Callaghy 1988: 1), informal activity, which is to say unrestricted market activity, appears to be growing. Simply put, it works better. The informal financial sector has proved robust even as the formal systems have become distressed (World Bank 1989a: 16).

It is interesting to note that traditional and quasi-traditional legal systems continue to operate in areas beyond the control of the central state (Callaghy 1988: 7). These systems may hardly embody classical liberalism, but their competition for jurisdiction may yet enhance the liberty of African citizens, much as Western liberties in large part grew fortuitously out of competition between the ecclesiastical courts and the various secular systems of feudal law, manorial law, mercantile law, urban law, and royal law (Berman 1983). The ability to flee from state controls into the informal sector is the citizen's most effective defense.[9]

The Market-Liberal Solution

The success stories of the "gang of four" newly industrializing countries of the Far East (Singapore, Hong Kong, Taiwan, and South Korea) are often cited, and justifiably so, as evidence of the efficacy of trade liberalization and market-led development. As Lal (1985: 45–47) notes, "Their success is almost entirely due to good policies and the ability of the people—scarcely at all to favorable circumstances or a good start." A deeper and wider, but similar, picture of market-led growth can be found by contrasting the histories of the original industrialized countries with other regions (see Rosenberg and Birdzell 1986).

In the same way much attention has been paid to recent experiences with financial liberalization in the southern cone (Argentina, Chile, and Uruguay), and in Korea and Turkey (World Bank 1989b: 122–26). A wider perspective on the consequences of financial liberty can be gained from studying the original historical cases of nearly laissez-faire banking in Scotland, Canada, and New England, among other cases, in contrast with countries where the state dominated the banking system. Rondo Cameron (1967: 313) concludes a volume of such comparative studies with the verdict that "insofar as the criterion for judging bank performance is the contribution of banks to growth, the best results have been achieved when competition was freest and most unfettered." He derives from a second volume of studies (Cameron 1972: 25) the reinforcing lesson that

> restrictions on freedom of entry almost always reduce the quantity and quality of financial services available to the economy, and thus hinder or

> distort economic growth. Competition in banking, on the other hand, acts as a spur to the mobilization of idle financial resources and to their efficient utilization in commerce and industry.

Freedom and competition allowed (and compelled) banks to develop and to innovate in ways most suited to their environments. Scottish banking in the early nineteenth century was rightly regarded as the most free *and* the most sophisticated in the world. The state did not restrict entry into banking, did not regulate interest rates or bank portfolios, did not guarantee deposits, and did not rescue failing banks. There was no central bank. Spurred by competition, the Scottish banks pioneered the introduction of interest-bearing deposits, overdraft accounts, and branch banking. They were sounder than their more state-restricted English counterparts, not prone to overextension and distress, and not troubled by runs or panics.[10] An important aspect of historical "free banking" was private issue of currency (banknotes), which set the profit motive to work in promoting the public's use of financial instruments and institutions (Cameron 1967: 31).[11]

By this standard—the degree of financial liberalism under which the West grew rich—the liberalization reforms currently suggested by the IMF and the World Bank do not go nearly far enough. They seem to be modeled on current regulatory policies in Western nations. They take central banking for granted. But recent works have cogently argued that Western financial institutions are overrestricted and distorted by the state and central banking is better avoided (Dowd 1989, Glasner 1989, Selgin 1989, Kane 1989). It is all the more crucial for the citizens of poorer nations to avoid expensive state interventions and institutions (see Olson 1987). Thus we have reason to be concerned, rather than reassured, that the World Bank "does advocate a significant role for the African state" and that its "strategies for African development do not question the involvement of the state" (Commins 1988: 2–3), particularly with respect to money and banking.

It is fairly easy to envision what the privatization and deregulation of the financial sector would entail: sale of solvent state-owned banks to private investors, liquidation of insolvent banks, open entry, enforceability for loan contracts, freedom from interest rate controls, no credit allocation or portfolio restriction schemes, an end to foreign exchange market intervention (White 1987). But even as badly as African central banks have performed, how could an African country today do without a local central bank to control its money stock? In the nineteenth century the basic money in each advanced nation was gold or silver coin, and the stock of money was accordingly regulated by the international flows of specie that adjusted the distribution of metals in accordance with relative demands to hold specie. (This process regulated the stock of money in the long run even in countries with central banks, provided their central banks did not suspend

convertibility or devalue.) A developing country today could similarly use a relatively stable internationally traded currency as its basic money. If it chose the dollar, its money stock would be regulated just as is the money stock of California, by flows adjusting the distribution of dollars in accordance with relative demands within the unified currency area. Its inflation rate would be held down to that of the United States. The common hand-to-hand currency would most advantageously be dollar-denominated banknotes issued by private banks.[12]

A reform of this sort (though without private note issue) has recently been adopted by an Eastern European nation aiming to speed its own development: East Germany has abolished its central bank by adopting the deutsche mark standard. It did so before any date had been set for, and in principle independently of, political unification with West Germany. Robert L. Hetzel (1990: 18–19) has enunciated well the case for such a reform:

> Governments desiring to establish a market economy can limit government intervention in the economy by limiting the ability of their central banks to produce unpredictable changes in the price level, to allocate capital, and to allocate foreign exchange. The most direct way to limit intervention of the central bank in the economy is to eliminate the central bank.
>
> . . . The existence of a central bank provides a continuing incentive for politicians under pressure to confuse money creation with wealth creation. The resulting inflation then leads to myriad interventions in the economy in the form of wage, price, interest rate, exchange market, and capital controls. Eliminating the central bank is one way of committing to a limited role for the state.

By adopting an external standard and eliminating their central banks, countries "eliminate the inflation, credit allocation, foreign exchange controls, overvalued exchange rate, and other mistaken policies that political systems under stress require of their central banks."

Milton Friedman (1973: 5–60), as Hetzel points out, has long advocated currency unification and abolition of the central bank for most developing countries, as the best means to bar inflationary finance, exchange rate repression, and exchange controls. These policies tempt governments with a short-run focus but strongly inhibit growth. Hetzel advises that other Eastern European nations could follow East Germany's lead and abolish their own central banks. This advice applies as well to African countries that recognize the need to limit the inflationary and interventionist proclivities of the state for the sake of development.[13]

Hetzel notes that converting the central bank into a currency board on an external standard, as advocated by Hanke and Walters (1991) and as practiced in Hong Kong, offers a second-best option for eliminating the discretion of the central bank. The disadvantage of the currency board

system is that the domestic government still has a role in the monetary system, one it can abuse (by devaluation) and one it can easily expand back into discretionary central banking. Two of the advantages of a currency board—that domestic rather than foreign currency would circulate and that seignorage from currency issue would not go abroad—can be captured while eliminating the central bank entirely, by allowing private banks to issue currency. Foreign currency would then be held only as bank reserves.

It should be emphasized that this sort of free banking arrangement does not have to be engineered: it only has to be legalized.[14] In highly inflationary countries freedom to use stable international currencies is usually sufficient for "dollarization" to occur spontaneously.

Economic advisers, almost by the nature of their role, are prone to see irrationality or market failure in private institutional arrangements they do not understand and to think that state intervention will rationalize things. They are prone to see remediable error, rather than pursuit of other goals, in the failure of state-owned institutions to promote development. Even in an era favorable toward liberalization, they are constantly tempted to reorient rather than abandon the top-down approaches of the past. The current literature on financial restructuring is replete with statements to the effect that we policy advisers can now reconsider what kind of financial institutions *we* want to "put into place" in developing economies. The sensible approach, however, is to dismantle and discard the obstacles to financial development (state-owned institutions and systems of legal restrictions) rather than to "restructure" or attempt to "rehabilitate" them.

It might be objected that I am pushing against an open door or being unduly critical of intellectual allies. The World Bank and the IMF are not innocent of the character of African states, it might be said: the placing of conditionality on their aid already implies the perception of a divergence between what would be good for African citizens and what the rulers want to do. I do not doubt that many at the multinational agencies recognize the divergence to some extent, but I would suggest that conditionality programs do not adequately address it.

The entire enterprise of "working with" less-developed-country governments and central banks to put into place externally prescribed policies would seem to be self-contradictory and self-defeating. It suggests not only that outside experts have the "true" understanding but that the mere transmission of expertise can transform local ruling elites into agents of progress. The World Bank's "Joint Program of Action for Sub-Saharan Africa," for example, as Jaycox (1988: 26; emphasis added) describes it, presumes that "there is a need to assist *governments* to increase rapidly their capacity to *manage their own economies* through developing both human resources and institutions." Such a statement of purpose presents

us with the paradox of "free market" advocacy by an agency that wants to keep the fingers of local states, and its own fingers, in the pie. In the end a program of assisting local states in economic management is antithetical to dismantling state economic controls and consequently incompatible with economic growth and development.

The economist John P. Powelson (1988: 174), having worked for the IMF for eight years, reached essentially this view through his personal experience:

> But after economic advising in Kenya for two years, which ended in 1974, and having written a large part of the Kenya National Plan, the five-year plan, including the chapters on macroeconomics and fiscal and monetary policy, I came to the conclusion that really what I was doing was primarily enhancing the power of the elites in Kenya and other places, and probably discriminating against the poor. . . . I could see that really what I was doing was putting out a propaganda device.

Structural assistance loans are an example of ostensibly good intentions undermined by inappropriate means. The World Bank and the IMF pay African governments to listen to their good advice, as though the problem were intellectual shortcomings of the ruling elites of recipient states (Jaycox 1988: 28, 31) rather than the rulers' perception of their self-interest. The agencies even "bribe them with their funds to employ good policies" (Powelson 1988: 176). The checks are cashed. But there is precious little evidence that this gives the World Bank or anyone else effective leverage in enlightening, much less in reforming, repressive regimes. It is more likely that it helps those regimes maintain their grip on power.

The World Bank's recent initiative of establishing a Multilateral Investment Guarantee Agency, to insulate private overseas investors against "expropriation, currency inconvertibility, and armed conflict" (Jaycox 1988: 46), may likewise end up supporting illiberal regimes, though this is not part of its stated purpose. By reducing the overseas investor's felt losses from expropriation and belligerency, the program will reduce his incentive to avoid investing in countries ruled by potentially expropriative and belligerent regimes. It will therefore reduce the market penalty to African states (the drying up of foreign private investment funds) of repressive policies. Greater illiberality will be able to survive.

The World Bank's current programs of "assistance in developing local institutions" in the financial area include the prescription of auditing procedures and capital-asset ratios. Several contributors to the present volume suggest that additional state supervision would be useful to prevent fraud and mismanagement in financial institutions. But we should consider that bank supervision by political agencies, in the United States as well as in Africa, has typically been an inferior and even corrupt substitute

for professional self-regulation. The chances for arms-length supervision of banks by political authorities are slender. The apparatus of state supervision is more likely to be harnessed for hand-in-pocket political favoritism.

We also find, earlier in this volume, well-meaning proposals for the hothouse cultivation of new financial products. There is little warrant for supposing that economists really know how to spot unfilled "gaps" in financial markets. Those who presume to know should be out selling new financial products in the marketplace, facing the market test for their innovations, rather than peddling their ideas to states or multinational agencies. It is not true, as Jaycox seems to suggest (1988: 22, 37), that Africans lack the requisite entrepreneurial skills. Such a view, implicitly condescending, is sometimes based on the historicist notion that we in the West have reached a higher "stage" of development. It has been effectively criticized by anthropologist Polly Hill (1986: esp. 51–65) and others (see in particular Kennedy 1988).

The multinational agencies' and foreign aid establishment's experiment in using the state as the vehicle for development must be judged a failure. As Goran Hyden (1983: 182) puts it: "The basic fallacy in official development aid is . . . that it can reach the powerless by going through the powerful." P. T. Bauer (1976: 21) has long since observed that "official aid does not descend indiscriminately on the population of the recipient country; it accrues to specific groups of people in positions of power and sets up repercussions often damaging to development, notably by contributing to the politicisation of economic life." Many have subsequently recognized that the primary tangible result of administering aid through the state sector has simply been the expansion of the state sector (Leeson and Nixson 1988: 70). Little or none of the aid may ever improve the lot of poor citizens (Lal 1985: 55). Skeptics of trickle-down theories would be well advised to turn their scrutiny here.

Often even the immediate objectives of aid programs are antithetical to fostering liberal and prosperous economies. Aid is extended with the aim of strengthening SOEs (Jaycox 1988: 28, 33, 39–42) rather than of abolishing them. The World Bank, for instance, continues to support state-owned DFIs.

Aid to local states is actually, and regrettably, likely to worsen the lot of the poor by strengthening the states that oppress them. Reliance on hard-won cooperation from local states leads donors to the view that political "fragility" and "instability"—that is, threats to the hegemony of an existing state—are to be avoided at all costs. An agency taking this view is destined to support and even to strengthen the existing local regime, no matter how repressive. Thus Callaghy (1989: 100) notes that "international assistance has been a continuous and pervasive factor supporting the emergence, consolidation, and survival of the Mobutu regime in Zaire."

The Agenda for Research and Reform

We need frank and sober studies of the character and behavior of African states in order to understand the barriers to development, and to financial development in particular. P. F. Leeson (1988) has called for just such a reorientation of development economics research. Scrutiny of African states has been uncommon in the development economics literature to date, perhaps because it "might produce advice uncongenial to recipient and donor governments" (Leeson 1988: 32). African governments and their foreign patrons are naturally happy to deflect attention away from the internal causes of their failures.

We need public choice research "to understand why governments behave as they do in the economic sphere," recognizing that they serve interests and have aims (Leeson and Nixson 1988: 64). This research would attempt to uncover the gainers and losers from state activity within African societies (what Leeson [1988: 36] calls their "internal class structure") and from international intervention. What interests do particular interventions serve and how? Who directs policy, and how do they profit? What are the unintended side effects of intervention, and to what further policies do these side effects give rise?[15] What has driven the central banks? Leeson (1988: 38) worries that "a policy aim of reducing drastically the size and ramifications of state operations may not be conducive to their proper study." But such an aim should not be a handicap to valid social science research any more than adherence to the aim of reducing disease is a handicap to medical research.

A lack of a serious consideration of the character and behavior of the state is evident in much development research. An example is provided in the present volume by Anthony Saunders's chapter (I apologize for singling one author out). Saunders tries to use the same framework to explain innovations both by private entrepreneurs and by state agencies. But private entrepreneurs are constrained to seek activities whose market value exceeds their costs. State agencies are not. Surely we need a public choice perspective on the state's objectives in financial intervention, under which is subsumed its sponsorship of new financial products. Governments are not motivated by the same concern for market profitability, and it would be naive to think that they aim to enrich *everyone*.

On the policy reform front, the most likely means to real progress for African citizens is for official Western agencies to stop aiding their ruling elites. In a nutshell, just say no to Mobutus. The progress that has occurred in dismantling socialist regimes in Eastern Europe would doubtless have been delayed by more extensive Western aid to the old regimes. Liberals in Hungary are currently worried that aid will flow in too quickly for them to achieve further progress at dislodging the state in the short run.[16] A genuine concern for the people of Africa requires resisting the preemptive

demands of those who claim to lead them. Like Eastern Europe, sub-Saharan Africa must "depoliticize its development strategy . . . and discard the autocratic government and the state capitalism" that have characterized its development policies (Ayittey 1987: 220).

This will, of course, not be easy. Autocrats do not wish to be dislodged, and opposition leaders powerful enough to dislodge them are naturally tempted to become autocrats themselves (indeed they may be driven by that temptation). A mercantilist rent-seeking culture is not readily replaced by a liberal culture. Foreign governments and multinational agencies are characteristically inclined to try to work with existing regimes. The pressure for change must come from the citizenry within (Frenkel 1972: 225–27). Lacking change in popular opinion about what reins can and should be put on the state, the abolition of the big state would probably be followed by its rapid reinvention (Leeson and Nixson 1988: 82). Private citizens and international agencies that wish to aid development by restraining African states should consider what can be done to facilitate the voice and exit of the African people (particularly rural farmers and out-of-power ethnic minorities) victimized by their states.

The emergence of democracy movements in a number of African nations in the 1990s and the growth of informal markets, as noted above, provide some basis for optimism. They may reflect, and may help to accelerate, a trend toward widening the set of independent African property owners and increasing the security of their property rights. If such an *embourgeoisement* is actually occurring, then the prospect is far brighter that financial research and reform can appreciably benefit the majority of Africans in the near future.

Notes and References

Jerry Jenkins, "Foreword"

Notes

1. Quoted from Volcker 1990.
2. This quotation is translated from *Guinea Ecuatorial, País Jóven: Testimonios Políticos* (Malabo, Equatorial Guinea: 1985) and appears in Klitgaard 1990: 8.
3. Documented in Wunsch and Olowu 1990.

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1. Lawrence H. White, "African Finance: Toward Understanding and Liberalization"

Notes

I am grateful to Richard Timberlake, George Selgin, and Jerry Jenkins for comments on an earlier draft. They should not be blamed for the remaining shortcomings.

1. Thus I speculated that an appropriate title for this volume would be *Cartesians on the Congo*.

2. The IDA is an arm of the World Bank providing concessional assistance to the governments of poor countries.

3. For a review of McKinnon's important and influential work see White 1991.

4. Here Warren Weinstein mentions Hernando de Soto's very pertinent work on the issue of contract enforceability in the context of the Peruvian informal sector. See de Soto 1989 and Jenkins 1988.

5. This range for reserve requirements may seem surprisingly high. Joseph Goodwin later notes that reserve requirements in Zaire are 60 percent.

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4. Roland Tenconi, "Restructuring of the Banking System in Guinea"

Notes

1. Repression of alleged political or economic crimes was severe. Out of seventy-one ministers and state secretaries who served between 1958 and 1971, nine were executed, eight died in jail, eight received life sentences, twenty were freed after spending various periods in jail, and five sought political asylum abroad. On the economic front thousands of Peuls (or Foulah, the largest ethnic group in the country), who were the main traders in the country, were jailed or executed.

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

3. The January 1986 currency exchange was no exception. Issuance of new notes totaled GF 24.3 billion while the amount of old notes presented for exchange

did not exceed GF 21.3 billion. The overall loss was subsequently reduced from GF 3 billion to GF 2.2 billion as notes that had been diverted by local authorities for GS 800 million were reimbursed by the government.

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

6. Parker Shipton, "Borrowing and Lending in The Gambia: Local Perspectives on Formal and Informal Finance in Agrarian West Africa"

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Notes

1. The term "informal," used to label an economic "sector" by Hart 1973, is used in this study in the conventional sense, meaning noninstitutional, unregistered, unregulated, and untaxed by government. This is not to suggest that unofficial systems have no formalities in the sense of custom or etiquette or that official systems are without hidden unregulated activities. In these other senses, of course, the "informal economy" is sometimes more formal than the institutional economy.

2. Other related findings are reported in Shipton 1990a, 1991, and 1992.

3. Two of the villages are in Foni Berefet District (Western Division); two in Niani District (MacCarthy Island Division), and one in Wuli District (Upper River Division). A sixth village studied in 1987 was discounted from tabulations because of a suspected sampling error.

4. Structured surveys were conducted in April and May 1987 and July through October 1988. The results of the latter were still being processed at the time of

writing in 1989, but examination of the preliminary data has benefited this chapter. The numbers of informants are net of those whose information was discarded as questionable.

5. Irrigated rice farming, practiced on schemes covering only a few thousand hectares in The Gambia, appears in only one of the sample villages.

6. The 1983 national census gives this distribution: Mandinko (40 percent), Fula (19 percent), Wolof (15 percent), Jola (10 percent), Serahuli (8 percent), and others (8 percent), including Arabic-speaking Mauritanians (Gambia 1986: 8). The Gambia's ethnic groups are somewhat interspersed geographically, and contact between them is frequent. In size of population the sample villages varied from 47 to 919 (1983 census).

7. Numerical findings from a dry-season survey may also represent these dealings because of the absence of "strange farmers" who move to The Gambia for the growing season.

8. In Mandinka the village is termed *sateo*, the ward or quarter *kabilo*, the compound *suo*, the work group *dabada*, and the cooking group *sinkiro*. See Weil 1971; Hopkins 1971; Dunsmore et al. 1976; Diop 1981; Berman et al. 1983; Derman et al. 1985 for further discussions of these units and of village social organization in general. See also Linares 1970 on the Diola of Casamance, Senegal, for an illustration of ethnic variation in social organization within the region.

9. Patriliny means that descent is reckoned through males and that groups of kin are constituted by these ties, in ideals or in practice. Virilocal residence means that a married couple (or polygynous family) resides with or near the natal kin of the bridegroom.

10. See Haswell 1975: 24n on interest-free lending among relatives in Genieri village.

11. Mandinka, Jola, and Manjago cash bridewealth appears sometimes to amount to less than D. 500, but among the Wolof bridewealths appear to fall around D. 1,000, and Fula bridewealths frequently exceed D. 2,000. Families of particularly well-educated or well-connected women may demand much higher bridewealth.

12. Robertson 1987 discusses the Senegambian "strange farmer" contracts in considerable detail, emphasizing the aspects of flexibility and adaptability. As he notes, Gambian labor policy has been more positively disposed toward strange farmers than Senegalese policy.

13. Rural Gambian lending for profit is covered in more detail in Haswell 1975; see also Shipton 1990b.

14. Relations between the endogamous Mauritanian merchants and Gambian autochthons have been roughly sketched (Shipton 1990b and sources cited there) but never documented in detail.

15. 1988 figure. In that year the World Bank, a major lender for the cooperatives, forced some to close down or amalgamate because of financial losses.

16. See Jones 1986: 15; Clark 1987: Table 1 for yearly figures from 1974–75 to 1985–86. Haswell 1975 describes some changes in groundnut marketing and credit patterns up to the mid-1970s.

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

18. Urban merchants are said to charge substantially higher interest for foreign

merchants borrowing for cross-border trade, perhaps because the risks of lending are high.

19. IBAS has issued credit (and training) to Gambian small entrepreneurs who pass a screening based on character assessment and a profitability assessment of the proposed businesses. Borrowers must have savings accounts, provide guarantees and collateral, and contribute 20 percent of the total amount of credit. Loan sizes may exceed D. 10,000; 11 percent interest is charged, an amount below bank rates. By February 1987 IBAS reported a repayment rate of about 90 percent. IBAS has tried to emphasize productive activities such as poultry, fishing, and agricultural tool manufacturing but also lends to retailers. IBAS had project officers only in Banjul, Barra, Bansang, Farafeni, and Basse, and most of its clients were based in and around these cities and towns.

20. The following few paragraphs on interest charges and their relation to Islam summarize some findings of Shipton 1991.

21. In the *ostusu* savings and loans are the same, since all members contribute to each in turn; whether one is borrowing or lending depends only on one's place in the cycle.

22. The Gambia Co-operative Central Banking and Marketing Union was reorganized in 1971 into the Gambia Co-operative Union Ltd., when its banking functions were transferred to the Gambia Commercial and Development Bank.

23. A specialized subsystem of the cooperatives up to 1988, when the World Bank forced its trimming for financial reasons, was a set of cooperative thrift and credit societies (CTCS). There were then about eighty, serving some 3,700 members. About 85 percent of these were women, but the societies were managed largely by men. Most of their members lived in the cities and towns. About 50 percent of them were small-scale traders; others included gardeners, tie-dyers and other artisans, and salaried workers including dockworkers. The CTCS combined savings and credit functions; D. 207,500 total savings were recorded in 1986. In the villages visited no man or woman interviewed had saved in or borrowed from a CTCS.

24. In 1987–88 the cooperatives in areas visited issued single superphosphate, compound NPK (15-15-15), and urea.

25. The Ministry of Finance and Trade estimated the rate of inflation at 11.6 in 1987–88.

26. In Africa this difference is usually most pronounced in societies with lineage-based kinship systems, such as Gambians have. See Shipton 1985.

27. See Gamble 1955: 1; Haswell 1975: 28; Dunsmore et al. 1976: 269. Some of the districts were based on and named after older political units that precolonial travelers sometimes called kingdoms. These units varied greatly in size and nature and no longer have official recognition.

28. Cooperative society committee members are chosen as representatives of individual villages. In public announcements about loan arrears, the names of villages (but not of individuals) are mentioned.

29. The choice of Action Aid as an example does not imply any judgment that its performance is either more positive or more negative than that of other private agencies operating in The Gambia.

30. In the case of Save the Children, Gambian village groups receive grants in the first year of assistance, 50 percent credit, 50 percent grant in the second, and no grant in the third.

31. The same problem exists in southern Senegal, a region served by many grant projects in recent decades.

32. See Mann et al. 1989 and the accompanying AskARIES Knowledgebase for case studies on private agency management and ways of addressing the problems these agencies typically encounter. A problem for private agencies in The Gambia is coordination among themselves, as organizations competing for recognition both in the countryside and in the capital. Coordination is lacking between European- and American-based private agencies, on the one hand, and international Muslim organizations on the other. Larger agencies can help by organizing conferences for them on "neutral" premises. The Gambia does not now have many strong indigenous PVOs, as Senegal does, and even those do little in the way of lending or savings mobilization, though there have been experiments. This too is an area where encouragement from international agencies and perhaps from government might prove valuable.

33. The last decision involved something of a trade-off. It might help to build farmers' confidence in depositing but might also make farmers fear their deposits will not remain secret and also subject the banks to local demands for sub rosa assistance through personal ties.

34. These proportions are likely to vary, however, according to the size of the previous harvest.

35. A PPMU survey found that in 1985–86, of 537 Gambian work groups (*dabadas*) surveyed, 421 procured fertilizer. Of these, 47 percent took it on loan from the cooperatives, 45 percent procured it with their own cash, and 8 percent received it through private lending channels. Presumably some of the fertilizer purchased or privately lent came indirectly from the cooperatives (Gambia 1985). Some Gambian fertilizer has lately been transported to Senegal for sale, the prices being higher there.

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7. Philippe Hugon, "The Impact of Adjustment Policies on African Informal Financial Systems"

This chapter has benefitted from numerous colloquia presentations and other unpublished papers on one or several informal financial groups and their functioning. In case they are not cited in the text of this chapter, I want to identify (and thank) here several individual scholars and practitioners whose research and thinking has surely benefited my own: E. Bloy, Cl. Dupuy, M. Lelart, J. L. Lespes, T. Liman, R. Mahieu, and P. Guillaumont. Of course, I am solely responsible for the final product.

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8. Joshua E. Greene, "Inflation in African Countries: General Issues and Effect on the Financial Sector"

The views expressed in this paper are those of the author and do not necessarily represent those of the International Monetary Fund.

Notes

1. Among the few papers are Chhibber et al. 1989, London 1989, and Rwegasira 1979.

2. Sub-Saharan Africa comprises all African countries except Algeria, Angola, Morocco, Namibia, South Africa, and Tunisia.

3. These reasons are not necessarily unique to African countries, as similar problems occur in many developing countries.

4. See Montiel 1988: 2–3.

5. Data for 1986 and 1987 were excluded so that the unusually large depreciations in the real effective exchange rate in high-inflation countries recorded for those years would not obscure the underlying relationship between exchange rate movements and the inflation rate during most of the 1975–1988 period.

6. There is an extensive theoretical literature on the interaction between devaluation and inflation. See, for example, Rodriguez 1978, Bilson 1979, Bond 1980, and Khan and Lizondo 1987.

7. The coefficient was negative because an appreciation in the nominal effective exchange rate, which is normally associated with less inflation, was recorded as an increase in the index.

8. This measure is somewhat flawed as a savings indicator because only savings at commercial banks are included. Data to examine trends in savings across banks and nonbank institutions were not readily available for a large number of African countries.

9. Ghana is one recent exception.

10. See, for example, McDonald 1983 and Khan and Knight 1985.

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9. C. S. Kimei, "The Impact of Monetary and Fiscal Policies on the Financial System in Tanzania"

Views expressed in this paper are those of the author and do not in any way represent the official position of the Bank of Tanzania.

Notes

1. Goldsmith 1955 and Gurley and Shaw 1955 were among the pioneering authors who provided evidence in confirmation of the proposition that financial growth is a necessary concomitant of real economic growth.

2. After rising from 3.2 percent in 1950 to greater than 8.0 percent in 1965, the ratio of nonmonetary financial assets to GDP had stagnated at an average of 8.1 percent from 1965 until 1980, sharply declining thereafter (Kimei 1986: 210).

3. See *Tanzania Daily News*, March 28, 1983.

4. Although there was a slight rise in the ratio of monetary assets to total wealth, I am inclined to believe that the extent of financial growth is more accurately measured by the ratio of nonmonetary financial assets, which reflects the growth of specialization and diversification of the financial asset menu, as well as the mere quantitative growth of monetary financial assets.

5. See the *Tanzania Daily News* of February 10, 1989, for a story of a cooperative union that procured fictitious crops in the amount of shs. 1.6 billion.

6. The open general license (OGL) system was reintroduced with the strong backing of the World Bank in 1988.

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Country: The Case of Recent Experiences in Tanzania." *World Development* 11(6) (June).

10. Patrick Plane, "Financial Crises and the Process of Adjustment in the Franc Zone"

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Notes

1. Because Mali only recently rejoined the union, this chapter discusses the monetary union only as constituted before June 1, 1984.
2. For a detailed analysis of the institutional mechanisms of the franc zone, consult the work of Patrick and Sylviane Guillaumont 1984.
3. For an econometric analysis of the factors explaining the evolution of the union's current accounts, see Plane 1988b.

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11. Anthony Saunders, "Nonbank Financial Innovations in East Africa"

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14. Lawrence H. White, "Separating Bank and State in Africa"

Notes

I would like to thank Jerry Jenkins and Richard H. Timberlake for comments, without implicating either in my views.

1. Marsden and Bélot suggest as a corrective that official donors should make "private sector development loans." One fears that such a program would encourage indigenous entrepreneurs to become grant seekers rather than the reverse.

2. As P. F. Leeson and F. I. Nixson (1988: 64–65) have argued.

3. Lal (1985: 108) has also noticed this parallel: "Despite their trappings of modernity, many developing countries are closer in their official workings to the rapacious and inefficient nation-states of 17th- or 18th-century Europe, governed as much for the personal aggrandisement of their rulers as for the welfare of the ruled." He then cites Adam Smith. This passage indicates that Lal did not really mean that the interventionist policies of developing countries were inexplicable or non-goal-directed when he characterized them as "irrational."

4. This work was originally published in 1968. I will cite an excerpt, entitled "Kleptocracy as a System of Government in Africa," reprinted in Ekpo (1979), a volume devoted to the question of corruption in sub-Saharan Africa. An article and a recent book by Ayittey (1987; 1993) similarly analyzes the "kleptocratic tendencies" of African ruling elites.

5. Thus M. G. Sri-ram Aiyer mentions, in discussion earlier in this volume, that bank management is better (and less corrupt) in Nigeria because, among other reasons, there is more competition among banks.

6. As this was first written, President Samuel K. Doe of Liberia was under military siege. Since that first draft, former Sergeant Doe is dead, Liberia has a provisional government, and there is substantial uncertainty beyond that.

7. See the chapters on Nigeria, Uganda, Sierra Leone, and Kenya, respectively by Victor A. Olorunsola, Nelson Kasfir, Dick Simpson, and Donald Rothchild, in Olorunsola 1972.

8. A West African studying at a European university recently told me that his only hope of helping to effect economic reform in his country was to become an adviser with the IMF or the World Bank. Being an internal critic is simply too dangerous.

9. Bates (1981: 81–87) gives examples from African farming of "a flight from the government-controlled market, and a massive diversion of produce into private channels of trade."

10. For details and qualifications see White (1984: 23–49) and (1990).

11. Cameron (1967: 31) proposes that less-developed-country (LDC) governments consider allowing local banks today to issue "a standard form of banknote such as the national banknotes of the [late nineteenth-century] United States and Japan." I have elsewhere made a similar proposal but based more on the early nineteenth-century Scottish model of unrestricted private note issue (White 1987).

12. Private note issue imparts a desirable "elasticity" to the composition of the money stock: see Selgin 1988. See also the text below regarding seigniorage. Panama has adopted the dollar standard, has avoided having a domestic central bank, and accordingly has had much lower inflation than its neighbors. It failed to allow its banks free issue of dollar-denominated banknotes, however, and so suffered a currency shortage when the U.S. government embargoed shipments of dollar bills as a punitive measure against its ruler in 1987. Liberia's experience with the dollar standard merits study.

13. The franc zone countries of West Africa, as described by Patrick Plane earlier in this volume, have adopted an external currency standard (the French franc) but have retained a local central bank.

14. "Sound money and free banking are not impossible; they are merely illegal" (Sennholz 1985: 83).

15. A model study in many of these respects is Bates's 1981 study of African agricultural policies. Krueger 1990 addresses in a general way the question of the dynamics of state intervention.

16. An encouraging sign for Eastern Europe is the penetrating analysis and consciously liberal reform plan set forth by one of Hungary's leading economists, János Kornai (1990). A discouraging sign for Africa is the absence, at least to my knowledge, of any similar statement from an indigenous intellectual leader.

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445

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-451-

Index

Action Aid, The Gambia, 150–51
Adjustment policies
  defined, 178
  for financial liberalization, 136–88
  impact on informal markets, 178–79, 188–90
  as liberalization, 183–84, 185–86
  recommended features of, 190–92
  to restructure economies, 184
  See also Structural adjustment
Africa Growth Fund, 358–62
Agricultural sector
  The Gambia
    credit and debt in, 136, 160–61
    credit policies of international agencies, 150–52
    credit practices in groundnut industry, 142–43, 157–58
    lending channels, 154–59
  Ghana, 85–86, 88
    credit policy for, 92, 98–99, 107
    export sector, 111
  Guinea, 40–41, 74, 83–84
  See also Cooperatives, The Gambia
Aiyer, M. G. Sri-ram, 126–27, 128–29, 131
Amalow, Ali Abdi, 202
Ames, Brian, 172, 308–9, 310
Amissah, Austin, 416
Andreski, Stanislav, 414, 415–16
Arditti, F. D., 320
Arrow, Kenneth, 320
Assidon, E., 188
Associative savings groups, 180
Ayittey, George B. N., 415, 416

Bagehot, Walter, 9
Bailey, A. A., 133
Balance of payments
  franc zone countries: factors contributing to weakness, 287
  monetary approach to, 240–41
Banking systems
  education requirement in, 32–33, 38
  mixed private, foreign, and state-owned enterprises, 18–20
  nationalized, 12, 18–20
  Angola, 18
  Botswana, 20, 31–32

Banking systems, (*continued*)
Ethiopia, 18
European: participation in African banking, 81–82
The Gambia: interaction with rural patrons, 152–54
Ghana
commercial and rural banks in, 88–89, 96–97
policies and legislation to improve, 98–101, 105–6
policies to restore confidence, 98–100, 106
regulation of, 96–97, 107–8
restructuring, 102–4, 108
Guinea, 18
collapse of, 46
corruption in, 71–72, 75, 80
foreign bank participation, 55, 69, 76–77, 80–82
new, reformed, 54–60, 73, 75–77, 82
profitability in, 58–60, 63t, 64t, 65t
specialized banks in, 40, 42–48, 50–54, 62t, 63t
Madagascar, 18
Malawi, 20
Mauritania, 19–20
Mozambique, 18
Nigeria, 376
Senegal, 36–37
Somalia, 18
Sudan, 20
Tanzania, 18, 77–80, 232–33
corruption in, 78–79
reforms in, 77–80
U.S.: participation in African banking, 81
Zaire, 20
Zambia, 20
See also Central banks; Commercial banks; Merchant banks
Banque Centrale de la Republique de Guinée (BCRG), 43t
Bates, Robert H., 417
Bauer, P. T., 423
BCEAO. *See* Central Bank of the West African States (BCEAO)
Bélot, Thérèse, 411, 412
Ben-Horim, M., 321
Benjamin, Nancy, 201, 265, 396–97, 405–6
Berg, Elliot, 413
Berg report, 413
Berman, Harold J., 418
Bhatia, Rattan, 288, 289
Birdzell, L. E., Jr., 418
Boissieu, C. de, 290
Borrowing and lending, The Gambia
accounting systems for, 15
bribes, tips, and payoffs, 144
kinship and family ties, 138–44
patterns of, 136, 138–45
See also Cooperatives, The Gambia
Bortolani, Sergio, 307, 308, 346
Breen, Richard, 401
Budget deficit, African countries, 264–65

Callaghy, Thomas M., 414, 415, 418, 423
Callier, Philippe, 130, 352, 390–91
Cameron, Rondo, 418–19
Capital market
Ghana
development of, 90, 94–96, 100
foreign capital in, 126
Guinea: foreign banks in, 55–57
See also Money market
Capital movements
rural-urban, 174, 175
Tanzania: flight, 271
Central Bank of the West African States (BCEAO), 273–75
Central banks
proposed role in developing countries, 419–21
role in African countries, 179
stance toward informal financial sector, 194–95
supervision by, 36–37
supervision of, 19, 31–32
Botswana, 31–32
Ghana, 90–92
credit allocation by, 98–100
supervision by, 97, 99, 101–2

Guinea
currency issue by, 49–50, 71–72
reorganization of, 51, 72
supervision by, 48–49
Nigeria: supervision by, 128–29
Tanzania, 79, 232–33
weakness of, 235, 238–46
CFA. *See* Communauté Financière Africaine (CFA)
Chandavarkar, Anand, 33, 128, 178, 191, 254, 256, 389, 406
Chhibber, Ajay, 210, 211, 216
Clark, R. H., 133, 147, 157
Coles, Julius, 81
Commercial banks
The Gambia, 152–54
role of, 179
Senegal, 36
Tanzania: weakness of, 246–51
Commins, Stephen K., 419
Communauté Financière Africaine (CFA)
African component of, 273
banking systems in countries of, 20
Guinea, 39–40
monetary policy of, 274
performance of countries within, 28–29
Competition
lack of, 22–23
proposals to achieve, 2–3
Guinea: in banking system, 61
Nigeria: among banks, 128
potential for, 37–38
Tanzania: absence in financial system, 251–52
Constraint-induced theory (of financial innovation), 319, 320–21
Contractual membership groups, 180–82
See also tontines
Cooperatives, The Gambia, 146–50, 154–55, 158–59
Corporate Restructuring Study, Ghana, 131
Corporations, Ghana, 104, 109
Corruption
problems of, 121–22
in statist government, 415–16
Credit system
The Gambia: informal, 141
Credit systems
controls in, 411–12
government-controlled, 12–14
impact on inflation, 214, 215f.
informal, 35
preferences of, 2
role of development finance institutions in, 12
The Gambia
informal rural area, 138–46
lending channels, 154–59
Ghana
allocation in, 92–93, 98–100
for cocoa industry, 93–94
control for expansion of, 93
policies to improve allocation in, 98–100, 107
Guinea, 44–45, 74, 82–83
Tanzania
demands of state-owned enterprises on, 238–40
nonperforming loans in, 260–61
See also Borrowing and lending, The Gambia; Cooperatives; Development finance institutions; Savings and credit associations
Credit unions, 367–69
Cuevas, Carlos, 167–68, 170, 173, 202, 373
Curb markets, 193
Currency
absence of hard, 361
in franc zone, 274–76
Ghana, 91
Guinea
domestic and foreign markets for, 72–74
with monetary reform, 54, 72–73
See also Exchange rate systems

Data sources
African countries: inadequacy of some, 264

Data sources, (*continued*)
The Gambia: surveys, interviews, and conversations, 134–36
Debreu, G., 320
Debt, external
African countries, 184
franc zone countries, 287
Ghana, 87–88
Decision making
role of cooperatives in, 146–50
in rural communities, 136–37
Deposit insurance programs, 21
Deposits
Ghana, 90–92, 98–100
Guinea: accounts, 57–58
Tanzania: commercial banking, 246–51
Development finance institutions
proposal to close, 2
repressive activities of, 411–12
role of, 2, 12–13, 179
support from World Bank, 423
Ghana
development and regulation of, 89, 96–97
problems of, 102
Tanzania, 233
Diop, Mohamadou, 8–9, 36–37, 81–82, 129, 202–4, 308, 313–15, 354–58, 372, 373, 394, 407–8
Dowd, Kevin, 419
Dunsmore, J. R., 134, 143, 144, 148
Dupuy, Cl., 179, 181

EACB (East African Currency Board), 243
Economic development
Guinea, 44–46
obstacles to, 413–14
World Bank strategies for African, 419–23
Economic performance
franc zone countries
attempts to improve slow, 287–88
Ghana, 85–87, 90
Economic Recovery Program (ERP), Ghana, 85, 86–88
Economic shocks
causes of, 13
effect on credit markets, 34
vulnerability to, 2
Guinea, 75
Elias Scharffenberger, Christine, 137
Equity markets
absence of, 35
policies limiting development, 412
requirement for, 22
venture capital initiatives, 197–98
Ghana, 90
Tanzania, 243
Exchange rate systems
impact on inflation, 214, 216, 217f., 226
informal markets, 216
Ghana
auction and official rates, 86
liberalization, 87, 105
reform, 86
Guinea
auction market, 54, 58
formal and informal, 42
Tanzania, 260–61

Financial growth
country alternatives for, 2311
hypothesis for restricted and unrestricted, 231–32
Financial innovation
market completeness theory of, 319, 320
causes of, 321–22
constraint-induced theory, 319, 320–21
East African countries
commercial product, 325t, 326–27
consumer sector, 324–26
financial process, 325t, 327–29
Financial institutions
inherited colonial, 12
lack of innovation in, 22–23
in developing countries, 12
local indigenous African, 363–66
management and mismanagement of, 13–15
need to build infrastructure of, 38
reforms, 18–20, 25

See also Credit systems; Development finance institutions
Financial sectors
common problems among, 17–18
effect of policy response to inflation, 223–27
growth strategies for, 231–32
impact of inflation, 219–23, 226
reflection of real economy, 14–15
reforms in, 23, 25–29
with liberalization, 186–88
Benin, 21
Ghana, 20; 88
adjustments and changes, 114–15t, 116t, 117t, 118t, 119t
performance of formal, 90–92
in rural areas, 104–5
structure of, 89
Guinea, 39–40, 71
Kenya, 19, 22
Nigeria, 19
Sierra Leone, 20
Tanzania, 77–80
performance of, 234
problems facing, 251–59
reform in, 77
structure of, 232
Uganda, 20
Zimbabwe, 19
See also Banking system; Constraint-induced theory; Development finance institutions; Market completeness theory
Financial sectors, informal
link to formal sector, 182–83
sub-Saharan Africa, 179–82
Tanzania, 79
Finnerty, J. D., 321, 322–23, 334–36t
Fiscal deficit
financing of, 264–65
relation to inflation, 265–67
Fiscal policy
relation to levels of inflation, 214
Ghana, 86, 87, 91
Guinea
related to state-owned enterprises, 47
Formal sector
link to informal financial sector, 26, 182–83, 194–204
The Gambia
link to informal sector, 171–72
Ghana
financial sector, 90–92
separate from informal sector, 109
Guinea: exchange rate system, 42
See also Banking system; Cooperatives; Credit systems
France (in CFA), 274–75
Franc zone. *See* Communauté Financière Africaine (CFA)
Friedman, Milton, 210, 420
Fry, Maxwell, 242, 411
Frydman, Sandra, 398

Gallagher, Mark, 416
Gelb, Alan, 76–77, 127–28, 130–31, 198, 201, 202, 263–64, 347, 394–96, 401, 405
Glasner, David, 7–8, 419
Goldsmith, Raymond W., 230
Gonzalez-Arrieta, C. M., 242
Goodwin, Joseph, 391–92
Goreux, J. L., 286, 289, 308, 309–10, 312–13, 316, 317
Government
as initiator of research and reform, 424–25
Ghana: spending by, 87
Guinea: from centralized to decentralized, 77
Government role
in allocation of financial resources, 411–12
in financial systems, 26
in ownership of enterprises, 414
in sponsoring innovation, 361
to promote institutions, 38
World Bank perception of, 419
East African countries: financial innovation, 323–24
The Gambia: in cooperatives, 146–50, 154–55, 158–59, 161
Guinea, 39–41
in banking system, 42

Government role
Guinea, (*continued*)
in bank restructure and operation, 55–57
with reform, 57
Greene, Joshua, 35, 80–81, 197, 269–70, 343, 351, 378–79, 389, 401–2, 408
Guillaumont, P., 289, 292
Gurley, J. G., 182

Hanke, Steve, 420
Harber, Richard P., Jr., 216
Hart, Keith, 254
Haswell, Margaret R., 134, 143, 144
Hetzel, Robert L., 420
Hill, Polly, 423
Honohan, Patrick, 34–5, 82, 198–99, 266–67, 311–12, 313, 402–3
Human resources, Ghana, 85
Hyden, Goran, 415, 416, 423

Import substitution, Ghana, 86
Income distribution, 13
Inflation
effect of persistent, 205
impact of inflation on financial sector, 219–23
policy response to, 223–26
theories explaining, 210–19
trend in rates of, 206–9, 226
Ghana, 86, 87, 91, 111, 124
Guinea, 73
Tanzania, 78, 79, 235
with monetary expansion, 240–41
relation to loan losses, 263
Informal financial sector, 26, 27–28
commercial paper and bills in, 37–38
conditions in Africa for existence, 179
definition and features of, 177–78
differences in practices, 179
impact of adjustment policies on, 178–79, 188–90
links to formal financial system, 26, 182–83, 194–204
rapid growth of, 37
segments of, 193
Tanzania: features, size, operation, and effect of, 254–56
types of, 179–82
Informal markets
risk taking in, 168–69
Cameroon, 170, 172–73, 189
financial institutions of, 362–66
free-market aspects of, 417–18
fungibility in, 170–71
The Gambia
borrowing and lending in, 136–46, 155–56, 160, 168–69
gathering information about, 135
interest charges of, 144–45
link to cooperatives, 149–50
link to formal sector, 171–72
Ghana
lack of integration with formal sector, 109
in rural areas, 104
Guinea, 41–42, 71
Ivory Coast, 189
Madagascar, 190
Niger, 189
Nigeria: effect of controls on, 169
Tanzania, 79
Innovation theories, 319
Interest rate policy
controls on, 411–12
in informal financial sector, 199
The Gambia
in informal market, 144–45
in Islamic banking, 134,135
Ghana: liberalization, 86, 91, 98–99, 109, 124–26
International agencies
The Gambia
potential role for, 153–54
role in borrowing and lending, 150–52
See also International Monetary Fund (IMF); Private voluntary organizations; World Bank
International Monetary Fund (IMF), 206, 211
Investment
levels of direct, 184
private, 130–31

venture capital, 197–98
Tanzania, 243–44
See also Equity markets; Stock exchanges
Islam, The Gambia
influence on banking methods, 134, 145–46, 165
role in family life, 137–40

Jacquemot, P., 188
Jaycox, Edward, 414, 421, 422, 423
Jenkins, Jerry, 346
John, K., 320

Kane, E., 321, 419
Kennedy, Paul, 423
Kimei, C. S., 77–80, 129, 171, 234, 235, 243, 253, 254, 270–71, 397–98
Kornai, János, 414
Krueger, Anne O., 416
Krumm, K., 288

Labor market, Tanzania, 259
Lal, Deepak, 413, 418, 423
Leeson, P. E., 414, 423, 424
Le Fort, Guillermo, 225
Legal framework
absence of, 415–17
for contracts enforcement, 15
for link of formal and informal sectors, 182–83
Tanzania, 79
Leith, Clark, 129, 173, 265–66,316
Lelart, M., 179, 181
Liman, T., 181
Locklin, Kenneth, 8, 358–62
London, Anselm, 216, 219
Long, Millard, 37–38

McKinnon, R. I., 5, 182, 230, 242, 411
Macroeconomic policy
requirement for stabilization, 15
Ghana
requirement for adequate, 109
Structural Adjustment Program as, 88, 102, 105, 107–14
Tanzania
effect of weak, 259–61
See also Central bank; Exchange rate system; Fiscal policy; Monetary policy
Mahieu, R., 180, 188–89
Malhotra, Promodh, 8–9, 349–51, 362–65, 372–74, 377–78
Manufacturing sector, Ghana, 86, 88
Market completeness theory (of financial innovation), 319, 320, 337–38
Marsden, Keith, 411, 412
Martin, G., 276
Mathieson, Donald, 8, 82–83, 268, 313, 348, 376–77, 391
Mercantilism, 414
See also government role
Merchant banks, 19
Mining sector
Ghana, 88
Guinea, 39–42, 71
Monetary policy
as factor in generating inflation, 211, 226
influence on informal market activity, 183
Ghana, 91
Guinea
banking system as part of, 54
elements of reform, 72–73, 123–24
Tanzania
effect of expansive real, 235–46
effect of ineffective central bank, 252–59
recommended, 235
Money market, Ghana, 89, 94, 99–100
Montiel, Peter, 210, 211, 214, 216
Mundell, Robert, 28

Narasimham, M., 254
Nationalization
of banking systems, 2, 12, 18
Ghana, 94–96
Natural resources, Ghana, 85–86

Ndofor, A. B., 9, 32–33, 170–71, 365–69, 371–72, 373, 377
Nixson, F. I., 414, 423, 424
North, Douglass C., 414
Nowak, M., 191
Nyriabu, C. M., 258

O'Connell, Stephen, 33, 409
Offshore banking, Mauritius, 351
Olson, Mancur, 419
Overseas Private Investment Corporation (OPIC), 358–59, 361

Parallel markets. *See* Informal markets
Patronage system
  role of financial sector in, 26
  state as agency for, 415
Paulson, Jo Ann, 200, 404–5, 408
Pendharkar, V. G., 254
Plane, Patrick, 293, 307, 309, 311, 316–17
Political shocks, Guinea, 75
Political systems
  restructuring with strong, 123
  obstacles to economic development, 413–14
  research and reform for, 424–25
  Tanzania: pressure on central bank, 254
  See also Corruption; Patronage
Porter, Robert, 31–32, 406–7
Powelson, John P., 422
Price system
  with inflation, 206–9
  Ghana
    controls, 86
    requirement for stability, 111–12
  Tanzania
    controls, 259, 260
    lack of real structure of, 79
  Uganda: with devaluation, 218
Private enterprises
  in Africa, 83
  Guinea, 47
Private sector
  growth of, 14
  recognition of importance, 2
  shift toward, 38
  Ghana: rural banks in, 89
  Guinea
    credit in, 47
    development of, 40–42, 44–46, 76
  Mauritania: banks in, 19–20
  Nigeria, 265
  Tanzania, 244, 265
Private voluntary organizations, The Gambia, 150–52, 197–98
Property rights
  abridgment of, 415, 417
  role of informal markets in enforcement of, 417–18
Public enterprises. *See* State-owned enterprises
Public policy
  recommended objectives of, 28
  response to inflation, 223–26
  sequencing in reform, 26–27, 34, 109–10
Public sector
  credit consumption by, 412–13
  Ghana: state-owned enterprises in, 87
  Guinea
    banking system personnel, 46, 57
    reduction of, 76
  Tanzania: credit demands of, 238–40, 244–46

Ramamurthy, G. V., 133, 147
Recessions, 13
Regulation
  effect of formal sector, 168–69
  Ghana
    amendments of, 100–101
    of banking system, 96–97, 100, 107–8
    requirement for improved, 112
  Ghana: of credit, 92
  Tanzania
    effect of, 259–61
    financial markets, 259–60
Remittances, The Gambia
  from overseas labor, 140, 175
  from urban to rural areas, 174–75

Research (in behavior of African states), 424–25
Robertson, A. F., 141
Rosenberg, Nathan, 418

Sanusi, J. O., 34, 125, 168–69, 201, 264–65, 375–76, 392–94
Sarris, Michael, 8, 123–24, 344, 398–400, 409
Saunders, Anthony, 8, 330, 343–52
Savings
  impact of inflation on, 242
  African countries, 363–69
  The Gambia: many forms of, 138
  Ghana: deposit mobilization policies, 98–100
  Tanzania: policy for, 243–44
  See also Associative savings groups
Savings and credit associations
  African countries
    locations and functions, 179
    role of, 174–75
    rotating (ROSCA), 366
  Cameroon, 174
  The Gambia, 146
  See also Deposit insurance programs; Tontines
Selgin, George A., 419
Shaw, E. S., 5, 182, 242, 411
Shipton, Parker, 138, 144, 145, 146, 148, 152, 159, 167, 168, 169, 171–75, 199–200, 379
Shocks. *See* Economic shocks; Political shocks
Siefert, Jane, 403–4, 409
Silber, W., 320, 321, 322, 333t
Social security system, Ghana, 90
Soulard, Alain, 71–75, 83–84
Stabilization policy
  franc zone countries, 290–95
  inflation reduction with, 224–27
State-owned enterprises
  aid programs perpetuate, 423
  debts of, 2, 12–14
  preference in credit market for, 12, 411–13
  Ghana, 95–96
  Ghana: reform and divestiture, 87
  Guinea, 40–41
  Guinea: credit policy, 45, 47
  Tanzania; credit demand of, 238–40, 244–46
Stock exchanges
  absence of African country, 361
  Ghana, 94–95, 100
  Kenya, 330–31
  Mauritius, 346
Structural adjustment
  defined, 178
  impact on informal financial sector, 183–92
Swindell, Kenneth, 141

Tammen, Melanie, 167
Tanzi, Vito, 255
Thillairajah, S., 390, 403
Tontines
  evolution of, 377
  functions of, 180–82, 371–72
  Cameroon, 174, 199, 365–66, 373
  Ghana, 377–78
  Nigeria, 375–76
  Senegal, 372
Toureille, Jacques, 125–26
Trade policy
  Ghana: liberalization, 87, 105
  Guinea: liberalization (1986), 58
  Tanzania, 259
Tuck, Laura, 134

UMOA. *See* West African Monetary Union (UMOA)
U.S. Agency for International Development (AID), 358, 361

Van Horne, J. C., 320, 321, 322–23, 333t
Van Til, Reinhold, 80, 124–25
Village Banks Project, The Gambia, 153

Wages (impact on inflation), 216, 218
Walters, Alan A., 420
Wangwe, S. M., 242
Weinstein, Warren, 197–98, 200–201

West African Monetary Union (UMOA)
franc zone countries, 273
circumvention of protective mechanisms, 288–90
compensatory financing of, 278–87
monetary relations with France, 274
reform of, 287–88
White, Lawrence, 267, 353–54, 400–401, 419
Wilson, Ulrike, 315–16, 371, 397
Wing, Michael, 133
Wolgin, Jerry, 8, 124, 168, 197, 202, 345, 390
World Bank, 293, 412, 415, 418
role in African development strategy, 419–23
Ghana
role in bank restructuring and financial reform, 103, 104–14
Guinea, 50
International Finance Corporation, 198

Yansane, Kerfalla, 75–76, 267–68, 310–11, 374–75